Request for Permission to Proceed with Formal Regulation Process To Amend Regulation Section 25106.5-1

BACKGROUND

During 1999, the Franchise Tax Board promulgated California Code of Regulations, title 18, section 25106.5-1, which addresses the treatment of intercompany transactions in a combined report context occurring on or after January 1, 2001. Regulation section 25106.5-1 generally follows the federal consolidated intercompany regulations (Treasury Regulation section 1.1502-13 et seq.) with respect to many of the issues in those regulations, but because income is not apportioned for federal purposes, Regulation section 25106.5-1 also provides applicable apportionment rules.

<u>Regulation Section 25106.5-1(e) – Simplifying Rules Issue</u>

For income tax purposes, gain or loss from intercompany transactions is ordinarily deferred until there is a triggering event, such as the sale of the item outside the group to a third party. Notwithstanding this general principle, both the California and federal intercompany regulations allow taxpayers in specified circumstances to elect to account for their income or loss from intercompany transactions on a "separate entity" basis. This election allows current recognition of income or loss from intercompany transactions. The election is governed by Regulation section 25106.5-1, subsection (e), for California tax purposes and Treasury Regulation section 1.1501-13, subsection (e)(3), for federal tax purposes.

Both the California and federal regulations include "simplifying rules" provisions. This election is included within those "simplifying rules." Regulation section 25106.5-1, subsection (e), authorizes federal "separate entity" elections to be effective for California tax purposes. Even in situations in which the taxpayer has not made a federal "separate entity" election, taxpayers can elect to recognize intercompany income or loss on a separate entity basis as long as they have "properly reported" the intercompany income or loss on a separate entity basis for federal or foreign national tax purposes.

After questions were raised regarding the proper sales factor treatment of intercompany transactions that are recognized on a separate entity basis from the above described election, staff received permission from this Board to hold interested parties meetings to discuss clarifying the regulation by amendment.

The first such interested parties meeting was held on April 21, 2010, allowing the public an opportunity to raise issues related to Regulation section 25106.5-1. Issues raised included the following:

- Retroactivity

At that meeting a comment was made requesting that the changes be prospective only and not retroactive. Staff responded to this comment in the Discussion Topics document for the second interested parties meeting stating:

> Pursuant to Revenue and Taxation Code section 19503(a), at its discretion, the Franchise Tax Board may prescribe that a regulation applies retroactively, if the underlying regulation relates to a statute that was enacted prior to January 1, 1998. Revenue and Taxation Code section 25016.5, the statute underlying the revisions to the intercompany transaction regulations, was originally enacted prior to 1998. Accordingly, the Franchise Tax Board may prescribe that the revisions to the intercompany transaction regulations be applied retroactively.

Staff provided a full discussion of the issue and copies of excerpts from the original rulemaking file for Regulation section 25106.5-1. Staff has consistently taken the position that taxpayers making a subsection (e) election to currently recognize income were not allowed to include associated receipts in their sales factors. (See *Chase Brass & Copper Co., Inc. v. FTB* (1977) 70 Cal. App. 3d 457.) The misinterpretation has only been an issue for a few taxpayers, and the amendments merely clarify the regulation. Accordingly, the amendments will be retroactive.

- Economic change to the group

At the first interested parties meeting, another comment was made to attempt to reverse the longstanding FTB position that there is no sales factor representation when a subsection (e) election is made. A full response was provided by staff explaining that the regulatory intent was that the sourcing rules in Regulation section 25106.5-1, subsection (a)(5), apply to all subsections of Regulation section 25106.5-1, including subsection (e). It was also explained that since it was not the original regulatory intent to allow intercompany receipts to be included in the sales factor when intercompany income is recognized under a subsection (e) election, it is not appropriate to change the regulation to reflect other than what was originally intended. The portions of the original rulemaking file expressed concern at the time Regulation section 25106.5-1 was adopted about possible manipulation if intercompany receipts were allowed to be included in the year of income recognition. During the original rulemaking process, it was explained that elimination of intercompany receipts "prevents duplication and is consistent with the concept of treating unitary entities as divisions of a single enterprise."

Some taxpayers have suggested that because the election results in current income recognition from intercompany transactions, as opposed to the normal scheme of deferral, that the sales factor for the year of election should contain the gross receipts related to the income recognized currently due to the election. If this were allowed, the effect is a larger sales factor denominator and therefore a reduction in California apportioned income. (The tax effect of the income taken into account currently due to the election is small, compared to the sales factor effect of the inclusion of the gross receipts in the sales factor denominator, resulting in a reduction of tax.)

Staff explained that it is prudent to clarify that a Regulation section 25106.5-1, subsection (e), election does not allow taxpayers to include intercompany transaction receipts in their sales factor denominator in the year of election. Instead, those receipts should be included in the sales factor only when the intercompany items are sold to third parties, giving rise to economic gain or loss to the group as a whole. If intercompany receipts were to be recognized currently due to the election, the receipts that arise when the items are eventually sold outside the group would result in a double counting of the actual economic activity in the sales factor. It was also explained that inclusion in the sales factor in the current year due to a subsection (e) election is inconsistent with Regulation section 25106.5(a)(5)(A) and (a)(5)(B).

Finally, it was explained that this issue should arise only in regards to transactions taking place the last month or two of the taxable year, as the transactions in earlier months of the taxable year would normally not be subject to an election because the inventory at issue would normally have been sold outside the group within that taxable year and therefore would have been already included in the sales factor by the triggering event of the outside sale. Double counting only the intercompany receipts from the last few months of a taxable year would be even more incongruent with the original intent of the regulation.

After the first interested parties meeting, language for the proposed amendments was drafted. The amendments included the following:

- Amend Regulation section 25106.5-1, subsection (e), to add specific references stating that this is an election to recognize intercompany transaction income or loss on a separate entity basis.

- Amend Regulation section 25106.5-1, subsection (a)(5)(A), to add a subsection (a)(5)(A)4 that indicates that sales factor sourcing located at subsections (a)(5)(A)1 through 3 applies even if a subsection (e)(2) election has been made.

- Amend Regulation section 25106.5-1, subsection (b)(6), to add a reference to subsection (a)(5) as follows, "Treatment as a separate entity means treatment without application of the rules of this regulation (other than the rules in subsection (a)(4) <u>and (5)</u>)..."

A second interested parties meeting was held on September 22, 2010, to allow the public an opportunity to provide comments on the proposed amendments. At this meeting comments were made that repeated those made at the first interested parties meeting, with examples provided. Staff responded in a manner similar to the first interested parties meeting, explaining that the amendments create redundancy and do not change existing law as intended and as explained through the years to the public.

Staff believes that the amendments to the regulation as proposed provide appropriate guidance regarding the sales factor treatment when there is an election made under subsection (e) and requests approval to commence the formal regulatory process to adopt the proposed amendments to this regulation.

<u>Regulation section 25106.5-1, subsection (f)(1)(B) - Deferred Intercompany Stock Accounts</u>

Pursuant to Internal Revenue Code section 301, subsection(c)(3), which California incorporates pursuant to California Revenue and Taxation Code section 24451, if a corporate distribution exceeds the distributor's earnings and profits and the distributee's basis in the distributor, the distributee must recognize gain to the extent of the excess distribution. According to the federal consolidated return regulations, an excess distribution will not lead to an imputed gain. Rather, the distributee will have a negative basis in the stock of the distributor. (See Treasury Regulation 1.1502-32.) The distributee will recognize the negative basis as gain when it disposes of the stock in the distributor. (See Treasury Regulation 1.1502-19.) However, due to constitutional limitations, these federal consolidated return regulations cannot be applied for California tax purposes.

To provide a means to defer gains from excess distributions within a combined reporting group, the combined report intercompany transaction regulations provide for the creation of a Deferred Intercompany Stock Account ("DISA"). (See Regulation section 25106.5-1, subsection (f)(1)(B) et seq.) Generally, the deferred gain is taken into income whenever the distributee disposes of shares of the stock in the distributor.

Since the combined report intercompany transaction regulations were promulgated, taxpayers have identified certain issues pertaining to the DISA rules that needed to be addressed. With this in mind, as an adjunct to revising the combined report intercompany transaction regulations for separate entity treatment purposes, a revision of the DISA rules was also investigated. At the interested parties meetings held on April 21, 2010, September 22, 2010, and August 16 2011, input was taken from the taxpayer and tax practitioner communities as to suggested revisions to the DISA rules. Accordingly, the following revisions were mutually agreed upon.

- Nonrecognition of DISA due to "brother/sister" merger.

Pursuant to the current version of Regulation section 25106.5-1, subsection (f)(1)(B), a DISA will be taken into income whenever the underlying stock to which it is attributed is disposed of. Generally speaking, when one member of a combined reporting group merges into another member of a combined reporting group, the stock of the merged entity is technically disposed of. This would then trigger the DISA being taken into income.

In an instance when combined reporting group members that are owned by the same member of the combined reporting group are merged into one another (commonly referred to as a "brother/sister" merger), then the DISA attributable to the nonsurviving member must be reported as income. However, because no assets have left the combined reporting group, there wouldn't be any economic change occurring to the group. Therefore, in order to permit continued deferral of the DISA attributable to the nonsurviving member's stock, revisions to the regulation were proposed so that the nonsurviving member's DISA will be combined with the DISA, if any, of the surviving member's stock. Thereafter, when the surviving member's stock is disposed of, the combined DISA will be recognized on a pro-rata basis. An example is included in the amended regulation to illustrate the appropriate treatment.

- Multiple DISAs resulting from a tiered distribution.

As addressed above, a DISA results because a distribution exceeds the distributor's earnings and profits and the distributee's basis in the distributee's stock. In the case of a tiered distribution, when a lower-tiered member distributes an amount of money or property to a higher-tiered member, who in turn distributes the same or lesser amount of money or the same property to an even higher-tiered member, if each distributor has insufficient earnings and profits and each distributee has insufficient basis in the stock of the distributor, the result would be that each distributee would have a DISA, even though essentially the same item was distributed.

Under the current version of Regulation section 25106.5-1, subsection (j)(4), the earnings and profits of a combined reporting group member do not reflect the results of any intercompany transactions. In the instance of a tiered distribution such as described above, if the DISA that results from the distribution from the lower-tiered member to the higher-tiered member is treated as creating earnings and profits for the distributee, then the distribution to the even higher-tiered member will not create a DISA because there would be sufficient earnings and profits. Revisions to Regulation section 25106.5-1, subsection (j)(4), were proposed to allow for this treatment. Additionally, two examples were included to illustrate the appropriate treatment.

- Subsequent capital contribution reducing an existing DISA.

As addressed above, under the federal consolidated return regulations included in Treasury Regulations section 1.1502-32, an excess distribution will not result in a deferred income item. Rather, the distributee will have a negative basis in its stock in the distributor. Pursuant to Treasury Regulations section 1.1502-32, thereafter if the stockholder contributes additional capital to the underlying corporation, the negative basis is adjusted accordingly and, if sufficient capital is contributed, it is eliminated. On the other hand, for California purposes, the existing DISA regulations do not contain a similar provision wherein a subsequent capital contribution could act to reduce and eliminate a DISA. (However, pursuant to California Revenue & Taxation Code section 24912, the stockholder's capital contribution would create basis in the underlying corporation's stock. But the DISA would still continue to exist.)

The tax practitioner community has pointed out that there are adverse non-tax consequences to not allowing a subsequent capital contribution to reduce and eliminate a DISA. A DISA is a deferred income item. As such, pursuant to the Financial Accounting Standard Board's Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN

48), for the year in which the DISA is created and every year thereafter, a provision must be included in the taxpayer's audited financial statements reflecting the potential tax burden associated with the deferred item. This has the effect of decreasing the net income reported for financial statement purposes. Even though existing California law allows a subsequent capital contribution to increase the basis in the underlying corporation's stock, unless there is an express provision allowing a subsequent capital contribution to reduce and eliminate a DISA, a corresponding tax provision must continue to be reflected in the audited financial statements.

To alleviate this adverse impact, revisions to the DISA provisions were proposed, allowing a subsequent capital contribution to reduce and eliminate an existing DISA. Examples are also provided to illustrate the treatment.

Regulation section 25106.5-1, subsection (a)(2) – Conformity to a portion of the federal consolidated return intercompany regulations, Treasury Regulation section 1.1502-13.

The current version of Regulation section 25106.5-1, subsection (a)(2), provides that the March 1997 version of Treasury Regulation section 1.1502-13 is applicable for California purposes. Since March 1997 there have been many revisions to Treasury Regulation section 1.5102-13. (The most recent version is current through April 2010.) Regulation section 25106.5-1, subsection (a)(2), will be revised to indicate that the updated version of Treasury Regulation section 1.1502-13 is applicable for California purposes.

Conclusion

Based on the foregoing discussion, staff requests that this Board grant staff permission to proceed with these proposed amendments to Regulation section 25106.5-1 into the formal regulatory process under the Administrative Procedure Act.

Summary of Interested Parties Meeting
Regulation §25106.5-1
Intercompany Transaction Regulation

I. Administration: On April 21, 2010 at 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board office in Sacramento. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Colleen Berwick for later correspondence. Phone participants introduced themselves. The session was to be tape recorded for reference but there would be no attribution of comments and no transcript. The Hearing Officers were Laurie McElhatton and Craig Swieso. Available handouts were: notice of the meeting, discussion topics, and a Deferred Intercompany Stock Account outline for discussion. Parties were told they had until May 3, 2010 to submit written comments. A summary of the interested parties meeting would be posted online. (Written comments may continue to be submitted after this deadline to assist with the drafting process.)

The purpose of the meeting was discussed as being a time for the public to discuss the possibility of amending the regulation to provide further guidance in two areas and to address conformity with federal laws.

II. Discussion: The discussion was organized topically, covering the following three areas:

- Discuss whether to provide further guidance regarding the proper apportionment treatment of intercompany transactions that are reported utilizing the simplifying rules of section Regulation section 25106.5-1, subsection (e).
- Discuss whether to amend Regulation section 25106.5-1, subsection (f)(1)(B), relating to Deferred Intercompany Stock Accounts, to provide further guidance addressing mergers, subsequent capital contributions and the effect of tiered distributions.
- Discuss whether to amend Regulation section 25106.5-1 to bring it into conformity with the most recent version of Treasury Regulation section 1. 1502-13.

A. The Simplifying Rules of Regulation section 25106.5-1, subsection (e)

Statement: The discussion was opened by Laurie McElhatton with a general statement regarding the simplifying rules located at subsection (e).

1. Deferral: For income tax purposes, gain or loss from intercompany transactions is ordinarily deferred until there is a triggering event, such as the sale of the deferred item outside the group to a third party.

2. Exception to deferral: Even though the general rule is deferral of intercompany income until a sale outside the group, both the California and federal intercompany regulations

allow taxpayers in specified circumstances to elect to account for their income or loss from intercompany transactions on a "separate entity" basis.

3. Election: This election allows current recognition of income or loss from intercompany transactions. The election is governed by Regulation 25106.5-1, subsection (e), for California tax purposes and Treasury Regulation section 1.1501-13, subsection (e)(3), for federal tax purposes.

4. Apportionment: While the subsection (e) election allows income or loss from intercompany transactions to be recognized in the year of the transaction, there was no intent to have taxpayers include intercompany receipts related to those transactions in their sales factors.

5. Proper sales factor treatment: The apportionment method that applies when there has been a subsection (e) election is set forth in Regulation section 25106.5-1 at subsection (a)(5) "Sourcing." It is this subsection (a)(5) that we want to be sure is given full effect. It states the following:

   > "(1) Sales attributable to intercompany items are not included in S's sales factor either in the year of the transaction or in the year(s) in which such intercompany items are taken into account."

6. Some taxpayers: have suggested that because the election results in current income recognition from intercompany transactions, as opposed to the normal scheme of deferral, that the sales factor for the year of election should contain the gross receipts related to the income recognized currently due to the election, which results in a higher sales factor denominator and reduced California apportioned income.

7. Possible Amendment: Staff believes that it is prudent to clarify that a Regulation section 25106.5-1, subsection (e), election does not allow taxpayers to include intercompany transaction receipts in their sales factor denominator in the year of election. Instead, receipts are only included in the sales factor when the intercompany items are sold to third parties, giving rise to economic gain or loss to group as a whole. If intercompany receipts were to be recognized currently due to the election, the receipts that arise when the items are eventually sold outside the group would result in a double count of the actual economic activity in the sales factor. Furthermore, inclusion in the sales factor in the current year due to a subsection (e) election is inconsistent with Regulation section 25106.5(a)(5)(A) and (a)(5)(B).

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Comments: The public was then asked for comments and the following topics were discussed:

1. Effective Date: Comment was made that the effective date should be prospective only because this is a "change" in the law, there was a lack of intent, and regulations are statutory so they should not be made retroactive. Response was that this is a clarification and it had not yet been decided whether amendments would be recommended to be retroactive.

2. Economic Change to Group: A comment was made that recognition of income should necessarily require inclusion of receipts from the intercompany transaction underlying the income. The response given was that the reason the receipts are not included in the sales factor at the time of the intercompany transaction under a subsection (e) election is because there has been no economic change to the group as a whole. Further comment was made disagreeing; saying that the fact that the income is being taxed currently means that there is an economic change. Response was that while there is taxation under the election, the fact that something is being taxed does not mean that there has been an economic change to the group as a whole. An asset has merely moved from one entity's books to another and an expense recorded in the other direction, with no overall change to the group. Further response was given that this issue is really only as to transactions in the last month of the taxable year. Those transactions in the first eleven months would normally not be subject to an election because for the most part, those would have been sold outside the group within that time and currently recognized by the triggering event of the outside sale, hence not needing an election for current recognition.

3. Double Counting: In addition to the lack of economic change to the group from intercompany transactions, another reason given for not including the receipts from the intercompany transaction in the sales factor was that this would effectively be a double counting of receipts, or more, depending on the number of intercompany transactions. Further comment was made that this could be a counting of receipts 100 times if there were that many intercompany transactions for a particular asset. Responsive comment was that the taxpayer community would not execute hundreds of intercompany transactions. The question was asked, how much is too much, five, 100, 200 intercompany transactions for the same asset? Another responsive comment was that the taxpayer does not have to make this election. It is entirely voluntary to accelerate this income and the purpose of it was ease of administration and simplification. A comment was that the problem is that the factor is so enormous compared to the tiny amount of income associated with it. Also raised was the question of whether the purposes of the federal and state elections are the same, since the California election was modeled after the Federal election. Since the purposes of the federal and state

elections are the same, it should be noted that the federal election is disallowed where it is driven by tax benefits.

4. Intent: The question was asked repeatedly why receipts associated with intercompany transactions that give rise to taxable income should not be included in the sales factor. Response was that this was not the intent of the Regulation 25106.5-1, subsection (e) simplifying rules. Further question was how the FTB knows what the intent was at the time of drafting. Response was that Ms. McElhatton had read the rulemaking file and there was no discussion of including the intercompany receipts in the sales factor when making a subsection (e) election. The comment that followed was that silence does not indicate intent. The response was that Ms. McElhatton will read the rulemaking file again and try to find documents that help to clarify intent.

Written Comments: Following the interested parties meeting, the following written comments were submitted:

1. Regulation section 25106.5-1 (e) should not be clarified. The election under Regulation section 25106.5-1(e) should apply to treat intercompany transactions on a separate entity basis for both income recognition and inclusion of gross receipts relating to those transactions.

2. The subsection (e) election is an election to treat intercompany transactions on a separate entity basis. Since the taxpayer must recognize the income or loss on a separate entity basis in the year of the election, it follows that the electing taxpayer should also include gross receipts associated with those transactions in its sales factor in the year of the election. If this is not done, then the income or loss will be apportioned using an apportionment formula that does not fairly reflect where or how that income or loss was generated and thus is flawed.

3. The FTB commented that the purpose of the subsection (e) election was to mirror the federal election that only addresses income or loss and not apportionment and the FTB recognized that federal consolidated return regulations are not subject to Commerce Clause or other constitutional constraints, unlike the FTB regulations. It is because FTB's regulations have constitutional constraints that there should be matching of income/loss with related gross receipts in the year of the election so that the income/loss is fairly apportioned to California.

4. Current mechanisms such as RTC section 25137 are in place to address any distortion problem. A rule to prevent distortion should not give rise to distortion by causing a mismatch of income and apportionment factors.

5. Double counting is not distortive per se. Rather; there are several cases that stand for the opposite view that inclusion of income necessitates representation in the factors. There are other means to cure distortion than amending Regulation section 25106.5-1.

6. Amendments to Regulation section 25106.5-1 to clarify existing law are not supported by law or equitable standards. There is no authority provided that a regulation may be clarified to address unintended consequences of application of the regulation. Taxpayers are entitled to rely on the laws in existence during the taxable year when the transactions were made.

7. "Treatment as a separate entity" is defined at Regulation section 25106.5-1(b)(6) which turns off all aspects of Regulation section 25106.5-1 other than the rules of subsection (a)(4). There is no carve out for subsection (a)(5). Therefore, the FTB did not intend to maintain application of the sourcing rules to a taxpayer that made the election to treat intercompany sales on a separate entity basis.

8. For legislation to be given retroactive effect the legislature must provide a clear statement of the public purpose for such retroactive legislation and this same burden should be met for legislative regulations.

B. <u>The DISA rules of Regulation section 25106.5-1 subsection (f).</u>

Craig Swieso opened the discussion with a presentation of the underlying DISA principles.

1. California's intercompany transaction regulations specifically provide that other existing law is applicable. Therefore, if the application of existing law allowed for a taxpayer's desired result there isn't any need to revise the regulations. Conversely, if the existing law doesn't allow the desired result, then the regulations must necessarily be revised in order to achieve the desired result.

2. The DISA rules encompass California's treatment of excess distributions in accordance with Internal Revenue Code section 301(c)(3), which California Revenue and Taxation Code section 24451 conforms to.

3. The intercompany regulations require all DISA balances to be reported annually on the tax return. If this doesn't occur, at its discretion, the FTB can take the unreported DISA balance into account.

4. The federal consolidated return regulations can't be relied upon in lieu of the DISA rules primarily because the federal stock basis adjustment rules are a function of unapportioned income, which includes income from whatever source. On the other

hand, due to constitutional limitations, by definition California-sourced income is apportioned and doesn't necessarily reflect nonbusiness income.

5. Pursuant to the DISA rules, any applicable Internal Revenue Code section 301(c)(3) gain is deferred until the underlying stock is disposed as the result of a sale, liquidation, or any other disposition. The deferred gain will also be taken into account when either the distributor or distributee ceases to be a member of the combined reporting group or if the associated stock is deemed worthlessness.

6. When the deferred Internal Revenue Code section 301(c)(3) gain is taken into account, it is sourced with reference to that year's apportionment factors.

7. California Government Code section 19146 prohibits the intercompany transaction regulations from repealing or diminishing any existing statute, including Internal Revenue Code section 301(c)(3).

8. The intercompany transaction regulations preclude any intercompany transactions from being reflected in any combined reporting group member's separate company earnings and profits.

Following this presentation, participants made the following comments.

1. In a brother/sister merger, the DISA attributable to the nonsurviving corporation's stock can be transferred and suitably allocated to the surviving corporation's stock. Thereafter, the DISA can be taken into account when the surviving corporation's stock is eventually disposed of. Accordingly, the DISA regulations should be revised to provide that a brother/sister merger won't cause a DISA to be taken into account.

2. As it is ordinarily applied, Internal Revenue Code section 301(c)(3) gain must be currently recognized in the year in which the excess distribution occurred. However, the DISA rules allow the gain to be deferred pending a triggering event. Prior to a triggering event, if a subsequent capital contribution is allowed to increase the distributee's basis in the distributor's stock, any corresponding deferred gain would be reduced or eliminated. This treatment would follow the federal treatment of determining the gain that must be recognized on the disposition of a consolidated return group member's stock wherein there is an associated negative basis. Accordingly, the DISA regulations should be revised to allow a subsequent capital contribution to reduce or eliminate the deferred Internal Revenue Code section 301(c)(3) gain. However, it must be pointed out that this treatment would provide for the elimination of deferred income, which isn't necessarily allowed under general tax principles.

3. Assuming that there aren't sufficient earnings and profits or stock basis attributable to any of the affiliates, if the same amount is distributed through a chain of tiered affiliates, it will create DISAs at each level. Accordingly, the DISA regulations should be revised to only require that one DISA is created if the same amount is distributed through a chain of tiered affiliates.

4. As the result of a triggering event, a combined reporting group member will be required to take any deferred Internal Revenue Code section 301(c)(3) gain into account. If the Internal Revenue Code section 301(c)(3) gain that is taken into account is treated as creating earnings and profits, any subsequent distribution by that member will correspondingly reduce or eliminate any DISA attributable to that distribution. Accordingly, the intercompany transaction regulations should be revised to allow Internal Revenue Code section 301(c)(3) gain that is taken into account to create earnings and profits for the distributee.

5. Presuming that California Government Code section 19146 prohibits the intercompany transaction regulations from repealing or diminishing an existing statute, the current intercompany transaction regulations violate this rule because they do in fact repeal or diminish existing statutes. For instance, California Revenue and Taxation Code section 25120 provides that sales include all gross receipts. However, the intercompany transaction regulations specifically provide that receipts from intercompany transactions can't be included in the sales factor denominator.

6. Subsequent to the Interested Parties Meeting, the following written comments were submitted.

   a. The elimination approach with respect to intercompany transactions is more consistent with the unitary business principle and combined reporting procedures as opposed to the deferral approach.

   b. When California Revenue & Taxation Code section 25106.5 was enacted, it shouldn't be presumed that the California Legislature granted the FTB with broad, quasi-legislative authority. Therefore, the FTB's authority to create the DISA regime is highly questionable. With this in mind, any regulations issued under California Revenue & Taxation Code section 25106.5 must be consistent with the unitary business principle, as well as California Revenue and Taxation Code sections 25101, 25106, and 25120 through 25139, as well as the case law that interprets this statutory provision.

   c. The DISA regime should not create phantom income to the unitary business through artificial, in not arbitrary, rules regarding basis and the calculation of earnings and profits.

d. The DISA rules should incorporate the federal consolidated return intercompany regulations basis and earnings and profits rules.

e. The intercompany transaction regulations should allow deferred income attributable to intercompany transactions to create earnings and profits.

f. The DISA regulations should be revised to allow subsequent capital contributions to reduce DISA balances. This treatment would be consistent with the basis rules contained in the federal consolidated return regulations.

g. Any type of merger should not trigger the DISA to be taken into account because no assets will have left the combined reporting group.

h. The revised DISA regulations should be applied on a retroactive basis.

C. <u>Conformity of Regulation section 25106.5-1 to Treasury Regulation section 1.1502-13</u>

There was only brief discussion regarding amending Regulation section 25106.5-1 to the most recent version of Treasury Regulation section 1.1502-13. Staff will review the Treasury Regulation and make recommendations regarding conformity.

Subsequent to the Interested Parties' Meeting a written comment was submitted. It was suggested that Regulation section 25106.5-1 be amended to provide that it incorporate the most recent version of Treasury Regulation section 1.1502-13 that is in effect for the year in which the relevant intercompany transaction occurs.

Summary of Second Interested Parties Meeting
Regulation § 25106.5-1
Intercompany Transaction Regulation

I. Administration: On September 22, 2010 at 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board's Sacramento central office. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Colleen Berwick for later correspondence. Phone participants introduced themselves. The session was tape recorded for reference but there would be no attribution of comments and no transcript. The Hearing Officers were Craig Swieso and Laurie McElhatton. Available handouts were: notice of the meeting, discussion topics, proposed language, Exhibits A through I, and a summary of the first interested parties meeting. Parties were told they had until September 29, 2010 to submit written comments for inclusion in the summary, but that they could also submit written comments at any time, and that a summary of the interested parties meeting would be posted online.

The purpose of the meeting was discussed as being a time for the public to discuss the proposed amendments to CCR § 25106.5-1 to provide further guidance in two areas and to address conformity with federal laws.

II. Discussion: The discussion was organized topically, covering the following three areas:

- Proposed amendments to CCR § 25106.5-1 providing further guidance regarding the proper apportionment treatment of intercompany transactions that are reported utilizing the simplifying rules of Regulation section 25106.5-1, subsection (e).

- Proposed amendments to CCR § 25106.5-1, subsection (f)(1)(B), relating to Deferred Intercompany Stock Accounts (DISA), to provide further guidance addressing mergers and the effect of tiered distributions.

- Proposed amendment to CCR § 25106.5-1, subsection (a)(2), to indicate that the intercompany transaction regulations incorporate Treasury Regulation 1.1502-13, as amended through April 1, 2009. Additionally, proposed amendments to include the IRS website address.

A. The Simplifying Rules of Regulation section 25106.5-1, subsection (e)

The discussion was opened with a request for comments on the proposed amendments pertaining to the simplifying rules.

- A comment was made that because taxpayers are agreeing to recognize intercompany income, that income should be included in the sales factor. A response was made that the rulemaking file was reviewed and summarized in Exhibit A with excerpts in Exhibits B through I and that this summary is the FTB's position on the intent of the simplifying rules. Another response was that over-reporting can be an issue if intercompany sales are included in the sales factor in the year of recognition under a subsection (e) election. Some examples were discussed:

  - One example was where a foreign group member makes a sale to a U.S. group member. The speaker stated that if the gain is recognized in California, then the proceeds should also be included in the sales factor.
  - The second example was a sale from a U.S. group member to another U.S. group member. The speaker thought that if an election were made on those facts to recognize the income currently, that the receipts should also be included in the sales factor.
  - The next example was for a worldwide combined reporting group and a sale from a foreign entity A to a foreign entity B and the reverse, from foreign entity B to foreign entity A. The public comment in this situation was that these would be transactions without economic substance and subject to a penalty but that there would be no reason not to include those receipts in the sales factor.
  - Then the last example was one with multiple tiers with foreign sub A selling to foreign sub B selling to foreign customer C. One comment was that this was not the situation they were concerned with. Another comment was made that this situation follows federal treatment and that the taxpayer should be allowed to make the election.

- A statement was made that it is rare for a federal election requiring permission to be approved and that there is a requirement that there be no greater benefit under the election than if a standard federal 1120 were filed. Another statement was made that taxpayers should simply not elect to recognize the income currently if they don't like the fact that there will be no sales factor representation.

- Another statement was made regarding constitutional implications and that there was no legislative intent for subsection (a)(5) to apply in instances of a subsection (e) election. In fact, the speaker claimed that these are not intercompany transactions and therefore CCR § 25106.5-1, subsection (a), does not apply at all.

- A comment was made that the exhibits from the rulemaking file quote general statements only and there are no express statements of intent regarding the sales factor and a subsection (e) election.
- A response was given that the reason for the subsection (e) election was to streamline recordkeeping rather than create an increased burden through deferral. Taxpayers can elect or not elect depending on their own circumstances. The point is that receipts from intercompany transactions, if included in the sales factor, would be counted once, and then upon sale outside the group, a second time. In addition, the intercompany sale in no way represents the market, which is what the sales factor is intended to measure.

- A statement was made that there is mismatching with deferral as there will be income coming in, such as for example with a foreign entity selling to a California entity.

- There was discussion about whether the regulation should be made to be retroactive. A speaker stated that it should not be retroactive as the interpretation being expressed by amendment was not the original intent. In addition, the speaker expressed concern that there may be penalties for taking the position in earlier years if the regulation is made retroactive. The speaker stated that making this regulation retroactive and subjecting taxpayers to penalties would not be a fair administrative practice.

B. DISA Rules of Regulation section 25106.5-1, subsection (f)(1)(B)

- It was mentioned that a stock redemption was affirmatively included as a transaction that will result in a stock disposition that will trigger the recognition of a DISA. There were no comments pertaining to this revision.

- It was mentioned that pursuant to California Revenue & Taxation Code section 19503, subdivision (b), the revisions to the DISA regulations would be applied retroactively. There were no comments pertaining to this statement.

- It was mentioned that when a subsidiary merges into a parent company, that operates as a liquidation. Pursuant to the language of the existing regulations, a liquidation will trigger the recognition of a DISA. Additionally, when a parent company merges into a subsidiary, that operates as a redemption. Pursuant to the revised language of the regulation, a redemption will trigger the recognition of a DISA. Accordingly, the only type of merger that needs to be additionally addressed is a brother/sister merger.

- It was mentioned that the reason the revised language provides that the relative DISAs pertaining to the non-surviving corporation's stock and the surviving corporation's stock are combined and then divided by the number of shares of the surviving corporation's stock after the merger is to ensure that a pro rata amount of DISA is recognized when the surviving corporation's stock is disposed of. In *Fujitsu It Holdings, Inc. v. FTB* (2004) 120 Cal. App. 4th 459, the issue of the pro ration of earnings and profits arose. The pro ration provision in the revised regulations will forestall a similar problem. There were no comments pertaining to this statement.

C. <u>Effect on Earnings and Profits from Intercompany Transactions Rules of Regulation section 25106.5-1, subsection (j)(4), as they Relate to DISAs.</u>

- With respect to the revisions pertaining to the creation of earnings and profits from tiered distributions, it was questioned why the revised language provides that it only relates to tiered distributions that are made immediately following one another. In response, the concern was about tracking distributions over a multitude of years. However, it was agreed that the distributions don't necessarily need to immediately follow one another. Accordingly, the term "immediately" will be excised from the revised language.

- It was also questioned why the same amount of money must be distributed in order to create earnings and profits from tiered distributions. Again, in response, the concern was about tracking distributions. However, it was agreed that a distribution involving a lesser amount of money should likewise create earnings and profits. Accordingly, another example will be added that includes a fact pattern involving a distribution of a lesser amount of money. (An example that includes a fact pattern involving a distribution of a greater amount of money is already featured in the revised language.)

- It was pointed out that according to the revised language, when a tiered distribution is received by the ultimate parent company, it will result in the ultimate parent company having earnings and profits. Accordingly, when the ultimate parent company makes a distribution to its shareholders, they must treat it as a dividend.

D. <u>Subsequent Capital Contribution Allowed to Reduce or Eliminate an Existing DISA</u>

- Although the revised language did not address this issue, it was significantly discussed during the meeting.

- It was pointed out that Regulation section 25106.5-1, subsection (f)(1)(B), specifically references Internal Revenue Code section 301, subsection (c)(3), as being the statutory basis for the DISA rules. Accordingly, because pursuant to Internal Revenue Code section 301, subsection (c)(3), the gain is necessarily recognized during the tax year when the excess distribution occurred, it follows that a capital contribution made in a subsequent year can't eliminate the gain. In response, it was pointed out that the existing version of

Regulation section 25106.5-1, subsection (f)(1)(B), requires that the gain from the excess distribution is deferred until the underlying stock is disposed of. Therefore, the existing regulation already diverts from Internal Revenue Code section 301, subsection (c)(3). Accordingly, allowing a subsequent capital contribution to reduce or eliminate an existing DISA would only be an extension of the FTB's ability to not be strictly bound by Internal Revenue Code section 301, subsection (c)(3).

- It was commented that the prior regulatory history of Regulation section 25106.5-1 includes a comment by FTB staff that *Safeway Stores, Inc. v. FTB* (1970) 3 Cal. 745 supports requiring current year recognition of gains from excess distributions. However, as the commentator pointed out, *Safeway Stores* pre-dates California's adoption of UDITPA. Therefore, despite FTB staff's prior comments otherwise, *Safeway Stores* has no bearing on the issue.

- It was asked that since the current version of California Revenue & Taxation Code section 25135, subdivision (b), reverts to the rule in *Appeal of Finnigan Corp*., 88-SBE-022, for purposes of recognizing any triggered DISA, will the excess distribution be considered on a separate company basis or cumulatively on the combined reporting group basis. In response, it was pointed out that because the purported reversion to the *Finnigan* rule would necessarily apply to all intercompany transactions, the inquiry is necessarily beyond the scope of this particular regulation project.

- It was asserted that because the DISA rules are tacitly based on the federal consolidated return regulation excess loss account rules (i.e. Treasury Regulation section 1.1502-19), which in turn must be considered in conjunction with the federal consolidated return basis adjustment rules (i.e. Treasury Regulation section 1.1502-32), which allow subsequent capital contributions to increase the stock basis, then similarly subsequent capital contributions should be allowed to increase stock basis for California purposes. However, it was pointed out that for federal purposes there aren't any constitutional limitations of what can be considered as income for basis adjustment rules which is the essence of Treasury Regulation section 1.1502-32. Because there are constitutional limitations on what can be included as California-sourced income, Treasury Regulation section 1.1502-32 cannot be relied upon for California purposes.

E. <u>Conformity with Most Recent Version of Treasury Regulation section 1.1502-13</u>

- Regulation section 25106.5-1, subsection (a), will state that, where applicable, it is in conformity with the version of Treasury Regulation section 1.1502-13 through April 2010.

- It was asked whether this revision will be applied retroactively. In response it was pointed out that since the most recent version of Treasury Regulation 1.1502-13 doesn't conflict with any existing provisions of Regulation section 25106.5-1, this revision will be applied retroactively.

F. <u>Subsequent Written Comments</u>

- Staff's proposed revision to Regulation section 25106.5-1, subsection (j)(4), should read as follows:

  > However, when a member distributes an amount of money or property to another member, who in turn thereafter makes a distribution to another member, any DISA arising from the initial distribution will be treated as earnings and profits from purposes of determining the DISA, if any, arising from the second distribution.

- Because the FTB mirrors the rules embedded in Treasury Regulation section 1.1502-19, the FTB should recognize the rules in their entirety, including the effect of subsequent contributions. Otherwise, phantom income will arise and additional record-keeping and compliance burdens will follow.

- Existing provisions of the California Revenue & Taxation Code, such as sections 24451 and 24912, conform to provisions of the Internal Revenue Code, such as sections 358 and 1012, respectively, which allow subsequent capital contributions to increase an asset's basis. Accordingly, independent of the intercompany transaction regulations, there is existing statutory authority to allow subsequent capital contributions to increase the basis in the stock of a unitary combined reporting group member.

- According to the existing DISA rules, any gain is deferred until there is a triggering event. Likewise, the measurement of the DISA should be deferred until there is a triggering event. In this instance, a subsequent capital contribution would be allowed to reduce or eliminate a DISA.

Summary of Third Interested Parties Meeting
Regulation § 25106.5-1
Intercompany Transaction Regulation

I. Administration: On August 16, 2011 at 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board's Sacramento central office. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Colleen Berwick for later correspondence. Phone participants introduced themselves. The session was tape recorded for reference but there would be no attribution of comments and no transcript. The Hearing Officer was Craig Swieso. Available handouts were: notice of the meeting, discussion topics, and proposed language. Parties were told that a summary of the interested parties meeting would be posted online.

The purpose of the meeting was to allow the public to discuss the proposed amendments to the Deferred Intercompany Stock Account (DISA) provisions of California Code of Regulations, title 18, (CCR) section 25106.5-1, subsection (f).

II. Discussion: The discussion was organized topically, covering the following four areas:

- Allowing subsequent capital contributions to reduce and/or eliminate an existing DISA balance.

- Creating earnings and profits for DISA purposes in instances involving tiered distributions to multiple combined reporting group members.

- General prospective or retroactive application of the proposed amendments.

- Application of recent federal consolidated return regulations revisions to DISAs.

A. Subsequent Capital Contributions

- Proposed revisions to CCR section 25106.5-1, subsection (j)(7), requires taxpayers to report changes to DISA balances due to subsequent capital contributions. However, the proposed language does not indicate the duration of this requirement. For instance, if a subsequent capital contribution eliminates a DISA in Year One, must the taxpayer continue to report the elimination in Year Ten?

- In response it was pointed out that FTB Form 3726 – "DISA and Capital Gain Information" is used to report DISA balances. FTB Form 3726 will be revised to report changes to DISAs due to subsequent capital contributions. Obviously the changes must be reported in the year that they occur. It has yet to be determined internally how many additional years, if any, the changes must be reported.

B. Creating Earnings and Profits in instances involving distributions to multiple combined reporting group members.

- Proposed revision to CCR section 25106.5-1, subsection (j)(4), provides that in instances when the same amount of money or the same property is distributed to one member, who immediately thereafter distributes it to another member, any DISA resulting from the initial distribution will be treated as earnings and profits for purposes of determining a DISA arising from the following distribution. It was asked why the second distribution must occur "immediately" following the first distribution? In many instances, an interval between distributions might occur. In such situations, the same treatment should be allowed.

- In response, it was agreed that the term "immediately" will be struck from the proposed revision to CCR section 25106.5-1, subsection (j)(4).

C. Prospective/retroactive application of proposed revisions.

- California Revenue and Taxation Code section 19503, subdivision (a), generally provides that revisions to CCR section 25106.5-1 be applied on a retroactive basis unless the Franchise Tax Board provides otherwise. It was asked if the FTB will seek to apply the revisions to the DISA provisions on a retroactive or prospective basis.

- In response, it was pointed out that the separate entity treatment provisions contained at CCR section 25106.5-1, subsection (e)(2), are also being revised. There have been comments from the public that these provisions should only be applied on a prospective basis.

- When asked if there would be any objections to the revisions to the DISA provisions not being applied on a prospective basis, none of the participants expressed any.

D. Application of recent federal consolidated regulation revision to DISAs

- In prior IPMs it was mentioned that the version of the federal consolidated return intercompany transaction regulations (i.e., Treasury Regulation section 1.1502-13), which is incorporated by CCR section 25165.-1, subsection (a)(2), will be updated. (The most recent version of Treasury Regulation section 1.1502-13 that is available online is current through April 2010.) On April 4, 2011, the Internal Revenue Service released Treasury Decision (TD) 9515 as part of Internal Revenue Bulletin 2011-14. In TD 9515 it was announced that on March 4, 2011, Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C), was being revised to provide for the exclusion of deferred gain attributable to an intercompany sale of stock when the consolidated reporting group member whose stock was the subject of the sale is liquidated pursuant to Internal Revenue Code section 332. (California Revenue and Taxation Code section 24451 incorporates Internal Revenue Section 332.) It was suggested that the DISA regulations be revised to specifically state that a DISA balance will be eliminated if it is attributable to the stock of underlying entity that is subsequently liquidated pursuant to Internal Revenue Code section 332.

- In response it was pointed out that the new version of Treasury Regulation section 1. 1502-13, subsection (c)(6)(ii))(C), pertains to gains from the intercompany sale of stock. On the other hand, DISAs arise due to excess distributions. Allowing the suggested treatment would be expanding the rule to a fact pattern not addressed in the revised Treasury Regulation.

- It was mentioned that the federal consolidated return regulations currently allow a liquidation to eliminate any potential gain relating to an excess distribution. Therefore, the new rule merely expands the same treatment to gains resulting from sales.

- In response it was emphasized that due to certain constitutional limitations, California is unable to adhere to the existing federal consolidated return regulations that currently allow a liquidation to eliminate any potential gain relating to an excess distribution.

- It was mentioned that pursuant to California Revenue and Taxation Code section 25106.5, the Franchise Tax Board possesses the statutory authority to apply the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii))(C).

- In response it was stated that although California Revenue and Taxation Code Section 25106.5 might provide the blanket authority to apply the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii))(C), that would necessitate additional Interested Parties Meetings. The regulation project to revise the DISA provisions of CCR section 25106.5-13 commenced approximately two years ago. To date, the revisions to the DISA provisions that have been vetted by the public have yet to be formally adopted under the Administrative Procedure Act. Additional Interested Parties Meetings to further vet the application of the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii))(C), will only further delay the probable formal promulgation of these revisions, which will further delay the practical favorable treatment afforded by them. In essence, there needs to be finality with respect to the revisions to the DISA provisions.

- It was suggested that the regulation project proceed, but that in the future the Franchise Tax Board should consider revising the DISA provisions to apply the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii))(C), as suggested.

E. Subsequent Written Comments

- CCR section 25106.5-1, subsection (f)(2), Example 10, states:
  Facts: P and S and T are members of a combined reporting group. P owns 100% of T's stock. P and T each own 50% of S's stock. P and T each have a separate basis in S's stock of $500. Due to an excess distribution, P has a $400 DISA attributable to its stock in S.

  The comment is that this is confusing because if P has a DISA with respect to its stock in S, then P would not have a basis in S's stock of $500.

- The confusion will be alleviated by revising the facts of Example to state: P and T each *initially had* a separate basis in S's stock of $500. (Emphasis added.)

- CCR section 25106.5-1, subsection (f)(1)(B)2., should be revised to allow P's subsequent purchase of stock from S to reduce any outstanding DISAs attributable to existing stock of S owned by P.

- This revision would potentially create administrative difficulties. The taxpayer and the taxing agency would be forced to track the basis pertaining to separate stock issuances. This difficulty would only be compounded if the purchase price of the additional stock cost didn't entirely eliminate a DISA attributable to existing stock.

- Proposed revision to CCR section 25106.5-1, subsection (j)(4), provides that in instances when the same amount of money or the same property is distributed to one member, who immediately thereafter distributes it to another member, any DISA resulting from the initial distribution will be treated as earnings and profits for purposes of determining a DISA arising from the following distribution. What is the policy reason why the second distribution must occur "immediately" following the first distribution? In many instances, an interval between distributions might occur. In such situations, the same treatment should be allowed.

- This matter was discussed at the Interested Parties Meeting and it was agreed that the term "immediately" will be struck from the proposed revision to CCR section 25106.5-1, subsection ())(4).

- CCR section 25106.5-1, subsections (f)(1)(B) and (f)(1)(B)3., should be revised to specifically state that a DISA balance will be eliminated if it is attributable to the stock of entity that is subsequently liquidated pursuant to Internal Revenue Code section 332 as provided in Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C).

- This matter was discussed at the Interested Parties Meeting. As addressed then, additional Interested Parties Meetings to further vet the application of the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii))(C), will only further delay the probable formal promulgation of the already vetted revisions to the DISA provisions of CCR section 25106.5-1. In essence, there needs to be finality with respect to the revisions to the DISA provisions. Furthermore, the application of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii))(C), might create problems when applied to fact patterns involving a DISAs arising from the distribution of appreciated property in which Internal Revenue Code section 311, subsection (b), applies. (California Revenue and Taxation Code section 24451 incorporates Internal Revenue section 311, subsection (b).)

Section 25106.5-1 is amended to read:

§ 25106.5-1. Intercompany Transactions.

(a) In general.

(1) Purpose. This regulation provides rules for taking into account items of income, gain, deduction, and loss of members of a combined reporting group from intercompany transactions. The purpose of this regulation is to provide rules for reporting intercompany transactions in order to clearly reflect the taxable income (and tax liability) of the taxpayer members that is allocated or apportioned to California. The general rule is one of deferring gains or losses from intercompany transactions in order to produce the effect of transactions between divisions of a single corporation.

(2) Conformity to Treasury Regulation section 1.1502-13. Intercompany transactions. Except as otherwise provided, this regulation incorporates Treasury Regulation section 1.1502-13, as amended through ~~March 17, 1997~~April 1, 2010, to the extent possible consistent with combined reporting principles to enable ease of administration and compliance. This regulation does not restate all the provisions of the federal regulation in full (a copy of which can be obtained ~~by going to the department's website at www.ftb.ca.gov or by mailing the request to the following address: California Franchise Tax Board, Legal Branch, Attn: Chief Counsel, P.O. Box 1720, Rancho Cordova, CA 95741-1720~~at www.irs.gov/taxpros), but the methodology of the federal regulation shall apply except as otherwise provided in this regulation. Exceptions will arise due to the differences between the composition of the federal consolidated group and the combined reporting group, the requirements of California's allocation and apportionment provisions, jurisdictional limitations, and treatment of members of a combined reporting group as separate entities for many purposes under the Revenue and Taxation Code. Further exceptions will arise in those instances when Treasury Regulation section 1.1502-13 incorporates by reference provisions of the Internal Revenue Code to which California has not conformed. Unless explicitly provided otherwise, conformity to Treasury Regulation section 1.1502-13 in no way implies conformity to any other regulation under section 1502 of the Internal Revenue Code.

(3) Timing rules as a method of accounting. This regulation applies the provisions of Treasury Regulation section 1.1502-13(a)(3), except for the reference to Treasury Regulation section 1.1502-17. The rules shall apply to all members of the combined reporting group.

(4) Other Law. Other applicable law (including nonstatutory authorities) shall apply in addition to the rules of this regulation to the extent that this regulation does not exclude such application.

(A) Non-applicability of section 304 of the Internal Revenue Code. As provided in Treasury Regulation section 1.1502-80, section 304 of the Internal Revenue Code, to which California conforms pursuant to section 24451 of the Revenue and Taxation Code, does not apply to any acquisition of stock of a corporation in an intercompany transaction occurring on or after the effective date of this regulation.

(B) Non-applicability of section 163(e)(5) of the Internal Revenue Code. As provided in Treasury Regulation section 1.1502-80, section 163(e)(5) of the Internal Revenue Code, to which California conforms pursuant to section 24344 of the Revenue and Taxation Code, does not apply to any intercompany obligation (within the meaning of subsection (g) of this regulation) issued in an income year beginning on or after the effective date of this regulation.

(C) Non-applicability of section 1031 of the Internal Revenue Code. As provided in Treasury Regulation section 1.1502-80, section 1031 of the Internal Revenue Code, to which California conforms pursuant to section 24941 of the Revenue and Taxation Code, does not apply to any intercompany transaction occurring in income years beginning on or after the effective date of this regulation.

(D) Non-applicability of Title 18, California Code of Regulations, section 25110(e). To the extent that the provisions of Regulation section 25110(e) are not consistent with the provisions of this regulation, this regulation will be controlling and Title 18, California Code of Regulations, section 25110(e) shall not be applicable.

(5) Sourcing. In the income year that intercompany items are taken into account, their source shall be determined as if the selling member (S) and the buying member (B) are divisions of a single corporation. Therefore, such intercompany items are treated as current apportionable business income and apportioned to California in accordance with sections 25120-25141 of the Revenue and Taxation Code. California law does not conform to the federal sourcing rules provided or referenced in Treasury Regulation section 1.1502- 13.

(A) Sales Factor.

1. Sales attributable to intercompany items are not included in S's sales factor either in the year of the transaction or in the year(s) in which such intercompany items are taken into account.

2. Gross receipts from the sale generating B's corresponding item will be included in B's sales factor in the year of the sale if otherwise included under section 25134 of the Revenue and Taxation Code, unless such gross receipts are excluded under Title 18, California Code of Regulations, section 25137.

3. Deemed sales under Treasury Regulation section 1.1502-13(d)(1)(ii) will be disregarded for purposes of the sales factor.

4. Subsections (a)(5)(A)1. through 3., above, shall apply regardless of whether an election is made under subsection (e)(2) of this regulation to

recognize income or loss from an intercompany transaction on a separate entity basis.

(B) Property Factor.

1. On the date of the intercompany transaction, the property transferred from S to B will be included in B's property factor at the original cost (within the meaning of section 25106.5 of the Revenue and Taxation Code) to S.

2. Intercompany rent expense is not included in the property factor.

3. Intercompany obligations otherwise includable under Title 18, California Code of Regulations, sections 25137-4.2 or 25137-10 shall not be included in the property factor.

4. If S's intercompany item is accelerated as a result of S or B no longer being members of the same combined reporting group, the value of B's property acquired from S in an intercompany transaction will be adjusted immediately after the acceleration event to reflect B's original cost (the purchase price paid by B to S).

5. Subsections (a)(5)(B)1. through 4. above shall apply regardless of whether an election is made under subsection (e)(2) of this regulation to treat an intercompany transaction on a separate entity basis.

(6) Overview. The principal rules of this regulation that implement single entity treatment are the matching rule of subsection (c) and the acceleration rule of subsection (d). Under the matching rule, Seller (S) and Buyer (B) are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. The acceleration rule provides rules for taking the items into account if the effect of treating S and B as divisions cannot be achieved (for example, if S or B leave the combined reporting group or if the asset transferred in the intercompany transaction is converted to nonbusiness use). Intercompany items will be treated as current apportionable business income for the year(s) in which the item is taken into account. Subsection (b) of this regulation provides definitions used in the application of this regulation. Subsection (e) of this regulation provides simplifying rules for certain transactions. Subsections (f) and (g) of this regulation provide additional rules for stock and obligations of members. Subsections (h) and (j) of this regulation provide anti-avoidance rules and miscellaneous operating rules. Subsection (i) of this regulation is reserved for future use.

(b) Definitions. For purposes of this regulation:

(1) Intercompany transactions.

(A) Except as provided in subsection (b)(1)(B), the term "intercompany transaction" means a transaction between corporations which are members of the same combined reporting group immediately after such transaction. "S" is the member transferring property or providing services, and "B" is the member receiving the property or services. Intercompany transactions include, but are not limited to -

1. S's sale of property (or other transfer, such as an exchange or contribution) to B;

2. S's performance of services for B, and B's payment or accrual of its expenditures for S's performance;

3. S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditures; and

4. S's distribution to B with respect to S stock.

(B) The term intercompany transaction does not include transactions which produce nonbusiness income or loss to the selling member or income attributable to a separate business activity of the selling member. The term intercompany transaction also does not apply when the asset transferred in the transaction is acquired for the buyer's nonbusiness use or for the use of a separate business activity of the buyer. For purposes of this regulation, such transactions shall be considered as if between corporations that are not members of a combined reporting group.

(2) "Combined reporting group" has the same meaning as defined in Title 18, California Code of Regulations, section 25106.5(b)(3). For purposes of this regulation, the members of the combined reporting group include:

(A) Both S and B, when the income and apportionment factors of those corporations are properly included in the same combined report for the income year of the intercompany transaction; and

(B) Any affiliated corporation (or portion thereof) whose income and apportionment factors are properly included in the same combined report in combination with the income and apportionment factors of S and B for that income year.

(3) Intercompany items.

(A) In general. S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. For example, S's gain from the sale of property to B is an intercompany gain. An item is an intercompany item whether it arises directly or indirectly from an intercompany transaction.

(B) Related costs or expenses. S's costs or expenses related to an intercompany transaction are included in determining its intercompany items.

(C) Amounts not yet recognized or incurred. S's intercompany items include amounts from an intercompany transaction that are not yet taken into account in computing its net income under its separate entity method of accounting.

(4) Corresponding items. B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

(5) Recomputed corresponding items. The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction was between those divisions. For example, if S sells property with a $70 basis to B for $100, and B later sells the property to a nonmember for $90, B's corresponding item is its $10 loss, and the recomputed corresponding item is $20 of gain (determined by comparing the $90 sales price with the $70 basis the property would have had if S and B were divisions of a single corporation).

(6) Treatment as a separate entity. Treatment as a separate entity means treatment without application of the rules of this regulation (other than the rules in subsections (a)(4) and (5)), but with the application of the other combined reporting regulations (as promulgated under the authority of section 25106.5 of the Revenue and Taxation Code). "Treatment as a separate entity" does not operate to prevent the income or loss taken into account under applicable rules for separate entity treatment from being properly characterized as combined report business income of the combined reporting group.

(7) Divisions of a single corporation. When S and B are treated as divisions of a single corporation for purposes of this regulation, such divisional treatment applies only to the unitary, apportionable trade or business operations included in the combined report. For example, neither nonbusiness income of S or B, nor income from activities of S or B that are excluded from a water's-edge combined report, will be considered for purposes of treating S and B as divisions of a single corporation.

(8) Deferred Intercompany Stock Account ("DISA"). DISA is the accounting mechanism that a distributee corporation, which is a member of the combined reporting group, will use to report and track non-dividend distributions in excess of its adjusted basis in the stock of the distributing subsidiary corporation, which is a member of the same combined reporting group, until this intercompany item is required to be taken into account pursuant to this regulation. The balance of each DISA account must be disclosed annually on the taxpayer's return.

(9) Attributes. The attributes of an intercompany item or corresponding item are all of the item's characteristics, except amount, location, and timing, necessary to determine

the item's effect on taxable income (and tax liability). For purposes of this regulation, "location" does not refer to geographical location, but instead refers to location within the combined reporting group, i.e., which member of the combined reporting group realizes the item.

(c) (NO REVISIONS)

(d) (NO REVISIONS)

(e) Simplifying Rules.

(1) Unless otherwise provided, this regulation applies the simplifying rules of Treasury Regulation section 1.1502-13(e). Differences may occur due to non-conformity with federal treatment, such as the treatment of bad debt reserves. However, to the extent bad debt reserves are allowed under the Revenue and Taxation Code, Treasury Regulation section 1.1502-13(e)(2) is applicable.

(2) Election to treat intercompany transactions on a separate entity basis.

(A) If members of the combined reporting group make a federal election to ~~treat~~ recognize income or loss from intercompany transactions on a separate entity basis under Treasury Regulation section 1.1502-13(e)(3), the taxpayer members will be treated as having made a similar election for California purposes, unless an election to the contrary is made for California purposes. A separate California election must be made by the taxpayer members to prevent the federal election from applying for California purposes. A taxpayer which is qualified to request federal consent to ~~treat~~recognize income or loss from intercompany transactions on a separate entity basis under Treasury Regulation section 1.1502-13(e)(3), but does not so request or is not granted consent by the Internal Revenue Service, may not elect such treatment for California purposes.

(B) If the members of the combined reporting group properly report income or loss from intercompany transactions on a separate entity basis for federal or foreign national tax purposes and subsection (e)(2)(A) of this regulation does not apply, the taxpayer members may elect to ~~treat~~recognize the income or loss from those intercompany transactions on a separate entity basis for California purposes. The election may be made for all items, or for items from a class or classes of transactions. For example, intercompany sales of inventory to a controlled foreign corporation included in a water's-edge combined reporting group pursuant to section 25110(a)(6) of the Revenue and Taxation Code may be considered a class of transactions for which a separate state election may be made.

(C) Elections described by subsection (e)(2) of this regulation are made by reporting income or loss from the intercompany transactions in the manner required by the election on a timely filed original tax return (not an amended return) for the first year to which the election is to apply. An election under this subsection shall be treated as an accounting method, and shall be effective for all intercompany transactions occurring in the year to which the election is first applied, and for each year thereafter.

(D) An election made under subsection (e)(2) of this regulation does not apply for purposes of taking into account:

1. losses and deductions deferred under section 267(f) of the Internal Revenue Code, or

2. items from intercompany transactions with respect to stock or obligations of members.

(f) Stock of Members.

(1) Unless otherwise provided, this regulation applies the provisions of Treasury Regulation section 1.1502-13(f) relating to stock of members; however, the provisions of subsection (f)(6) of that section shall not apply.

(A) Exception for distributee member. Treasury Regulation section 1.1502-13(f)(2)(ii) shall not apply to exclude intercompany distributions from the gross income of the distributee member. Intercompany dividend distributions described by section 301(c)(1) of the Internal Revenue Code are included in the income of the distributee member unless subject to elimination or deduction under other applicable law, including sections 25106 or 24402 of the Revenue and Taxation Code. The treatment of intercompany distributions described by section 301(c)(3) of the Internal Revenue Code is provided by subsection (f)(1)(B) of this regulation.

(B) Deferred intercompany stock account (DISA). That portion of an intercompany distribution which exceeds California earnings and profits and P's basis in S's stock (the portion of a distribution described by section 301(c)(3) of the Internal Revenue Code) will create a DISA. In this subsection, P is treated like the Buyer (B) for purposes of calculating corresponding and recomputed items.

The DISA will be treated as deferred income. To the extent of a sale, liquidation, redemption or any other disposition of shares of the stock, the balance of the DISA with respect to such shares will be taken into account as income or gain to P even if S and P remain members of the same combined reporting group. The disposition shall be treated as a sale or exchange for purposes of determining the character of the DISA income or gain. The DISA is held by the distributee.

1. A disposition of all the shares shall be deemed to have occurred if either S or P becomes a non-member of the combined reporting group or if the stock of S becomes worthless.

2. A disposition of stock will not occur when members of a combined reporting group merge into one another, if the majority of the voting shares

of the stock of each is owned by other members of the combined reporting group. The amount of DISA that is attributable to each share of the surviving member's stock following the merger will be the sum of the DISA attributable to the non-surviving member's stock prior to the merger, plus the DISA attributable to the surviving member's stock prior to the merger, divided by the number of shares of the surviving member's stock following the merger. Thereafter, the amount of DISA attributable to the surviving member's stock following the merger must be taken into account as income or gain when it is disposed of.

If a DISA has been created as the result of an intercompany distribution, prior to P's disposition of the S stock, the DISA will be reduced by any subsequent capital contributions that P makes to S. Once a DISA has been eliminated as the result of subsequent capital contributions, any further subsequent capital contributions will then increase P's basis in the S stock in accordance with section 24916 of the Revenue and Taxation Code.

~~2~~3. Because P's DISA is deferred income and not negative basis, the DISA is taken into account upon liquidation, including complete liquidation into the parent. The deferred income restored as a result of the liquidation will be taken into account ratably over 60 months unless the taxpayer elects to take the income into account in full in the year of liquidation. For example, if S liquidates and the exchange of P's S stock is subject to section 332 of the Internal Revenue Code (section 24451 of the Revenue and Taxation Code), P's DISA income taken into account under subsection (f)(1)(B) of this regulation is recognized over 60 months, unless an election is made to recognize the deferred income in the year of liquidation. Nonrecognition or deferral shall not apply to DISA income or gain taken into account as a result of an event described in subsection (f)(1)(B)1. of this regulation.

~~3~~4. If P transfers the stock of S to another member of the combined reporting group, P's DISA income will be an intercompany item and deferred under the rules of this regulation. If the other transferee member of the combined reporting group to whom P transfers the S stock already possesses S stock with a positive basis, any outstanding DISA attributable to the shares transferred by P will be reduced by the basis in the stock already possessed by the other member of the combined reporting group.

~~4~~5. If, on the effective date of this regulation, a closing agreement has been executed with the Franchise Tax Board to defer income from distributions described under section 301(c)(3) of the Internal Revenue Code, then such income shall be included in the DISA of the distributee member to the extent that it has not already been taken into account in the income of the distributee member. *Thereafter, the balance of the DISA account shall be taken into account under the rules of this* regulation.

~~5~~6. If P receives an intercompany distribution described by section 301(c)(3) of the Internal Revenue Code in an income year beginning prior to the effective date of this regulation, the taxpayer may request a closing agreement under section 19441 of the Revenue and Taxation Code that will allow the gain from the distribution to be deferred in a manner consistent with the provisions of subsection (f)(1)(B) of this regulation. The request shall be mailed within one year after the effective date of this regulation and within the applicable statutes of limitations on deficiency assessments or refund claims for the year of the distribution. The request shall describe the parties to the transaction, including federal identification numbers, the nature of the distribution, the timing and amounts of the income involved, and any other relevant facts. Requests shall be mailed to the following address: California Franchise Tax Board, Legal Branch, Attn: Chief Counsel, P.O. Box 1720, Rancho Cordova, CA 95741-1720.

(2) Examples. The application of this section to intercompany transactions with respect to stock of members is illustrated by the following examples.

Example 1: Dividend exclusion and property distribution.

(Refer to Treas. Reg. s 1.1502-13(f)(7), example 1.)

Facts. S owns land that is used in the trade or business of the combined reporting group with a $70 basis and $100 value. On January 1 of Year 1, P's basis in S's stock is $100, and S has accumulated earnings and profits of $500 from prior years' combined reports of S and P.

During Year 1, S declares and makes a dividend distribution of the land to P. P also uses the land in the unitary business. Under section 311(b) of the Internal Revenue Code, S has a $30 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the land is $100. (California law generally conforms to Internal Revenue Code sections 301-385 under section 24451 of the Revenue and Taxation Code.) On July 1 of Year 3, P sells the land to Y for $110.

Dividend treatment. S's distribution of the land is an intercompany distribution to P in the amount of $100. Because the distribution is paid out of earnings and profits of S, which have been included in a combined report of S and P, it will be eliminated from P's income pursuant to section 25106 of the Revenue and Taxation Code. The payment of the dividend has no effect on P's basis in the stock of S.

Matching rule. Under the matching rule (treating P as the buying member and S as the selling member), S takes its $30 intercompany gain into account in Year 3 to reflect the $30 difference between P's $10 corresponding gain ($110-$100 basis in the land) and the $40 recomputed gain ($110-$70 basis that the land would have had if S and P were divisions).

Apportionment. The intercompany distribution is not reflected in the sales factor in Year 1. In Year 3, unless otherwise excluded, the $110 gross receipts from P's sale of the land will be included in P's sales factor. After the distribution in Year 1, the land will be included in P's property factor at S's $70 original cost basis. Both S's $30 gain and P's $10 gain relative to the distributed land will be treated as current apportionable business income in Year 3.

Example 2: Dividends paid from pre-unitary earnings and profits.

Facts. The facts are the same as in Example 1 except that S's earnings and profits from prior combined reports of S and P is only $10. S also has $490 of earnings and profits that arose in years before a unitary relationship existed between S and P.

Dividend treatment. Because only $10 of S's distribution was paid from earnings and profits attributable to business income included in a combined report of S and P, only $10 is eliminated under section 25106 of the Revenue and Taxation Code. The remaining $90 of the dividend will be taken into account by P in Year 1, subject to any applicable deductions under sections 24402 or 24411 of the Revenue and Taxation Code.

Matching rule. P's corresponding item is not its dividend income, but its income, gain, deduction or loss from the property acquired in the intercompany distribution. Therefore, none of S's intercompany gain will be taken into account in Year 1. As in Example 1, S will take its $30 intercompany gain into account in Year 3 to reflect the $30 difference between P's $10 corresponding gain and the $40 recomputed gain.

Apportionment. The apportionment results are the same as in Example 1, except that to the extent that the Year 1 dividend is not eliminated under section 25106 or deducted under sections 24402 or 24411 of the Revenue and Taxation Code, P's dividend income will be treated as current apportionable business income in Year 1. The intercompany distribution is not included in the sales factor in Year 1.

Example 3: ~~Deferred intercompany stock accounts~~DISAs.

(Refer to Treas. Reg. s 1.1502-13(f)(7), example 2.)

Facts. S owns all of T's stock with a $10 basis and $100 value. S has substantial earnings and profits which are attributable to business income included in a combined report of S, T and P. T has $10 of accumulated earnings and profits, all of which are attributable to business income included in a combined report of S, T and P. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b) of the Internal Revenue Code, S has a $90 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the T stock is $100. During Year 3, T borrows $90 from an unrelated party and declares and makes a $90 distribution to P to which section 301 of the Internal Revenue Code applies. During Year 6, T has $5 of current earnings which is attributable to business income included in the combined report of S, T and P. On December 1 of Year 9, T issues additional stock to Y and, as a result, T becomes a nonmember.

Dividend elimination. P's $100 of dividend income from S's distribution of the T stock, and its $10 dividend income from T's $90 distribution, are eliminated from income under section 25106 of the Revenue and Taxation Code.

Matching and acceleration rules. P has no ~~deferred intercompany stock account (~~DISA~~)~~ with respect to T stock because T's $90 distribution did not exceed T's $10 of earnings and profits and $100 stock basis. Therefore, P's corresponding item in Year 9 when T becomes a nonmember is $0. Treating S and P as divisions of a single corporation, the T stock would continue to have a $10 basis after the distribution from S to P. T's $90 distribution in Year 3 would first reduce T's $10 earnings and profits to zero, then reduce the $10 recomputed basis in T stock to zero and create a $70 recomputed DISA. T's $5 of earnings in Year 6 does not affect the amount of the DISA. Because the recomputed DISA would be taken into account upon T becoming a nonmember in Year 9, P will have a $70 recomputed corresponding item. Under the matching rule, S takes $70 of its intercompany gain into account in Year 9 to reflect the difference between P's $0 corresponding gain and the $70 recomputed gain. S's remaining $20 of gain will be taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember or if the stock of T becomes a nonbusiness asset.)

Apportionment. Neither the distributions in Years 1 and 3, nor T becoming a nonmember in Year 9, have any effect on the sales factor. S's $70 intercompany gain will be treated as current apportionable business income in Year 9.

Example 4: ~~Deferred intercompany stock accounts~~DISAs, reverse sequence.

(Refer to Treas. Reg. s 1.1502-13(f)(7), example 2(d).)

Facts. The facts are the same as in Example 3, except that T borrows the $90 and makes its $90 distribution to S before S distributes T's stock to P. To the extent of T's $10 earnings and profits, T's distribution to S is a dividend and is eliminated under section 25106 of the Revenue and Taxation Code. The remaining distribution reduces S's $10 basis in T stock to $0, and creates a $70 DISA. The fair market value of T's stock after T incurs the $90 debt and distributes the proceeds is $10. Under section 311(b) of the Internal Revenue Code and the provisions of this regulation, S has an $80 gain from the distribution of T stock to P ($10 value less $0 basis, plus $70 DISA recaptured). Under section 301(d) of the Internal Revenue Code, P's initial basis in the T stock is the $10 fair market value of the stock. T's $5 of earnings in Year 6 has no effect on P's basis in the T stock.

Matching and acceleration rule. P's corresponding item in Year 9, when T becomes a nonmember, is $0. Treating S and P as divisions of a single corporation, the T stock would continue to have a $0 basis after the distribution from S to P, and a $70 balance would remain in the DISA. When T becomes a nonmember in Year 9, P must include the amount of its DISA in recomputed income, and therefore has a $70 recomputed corresponding item. Under the matching rule, S takes $70 of its intercompany gain into account in Year 9 to reflect the difference between P's $0 corresponding gain and the $70 recomputed gain. S's remaining $10 of gain will be taken into account under the matching and acceleration rules based on subsequent events.

Apportionment. Neither the distributions in Year 1 nor T becoming a nonmember in Year 9 have any effect on the sales factor. S's $70 intercompany gain taken into account in Year 9 is treated as current apportionable business income in Year 9.

Example 5: Partial stock sale.

(Refer to Treas. Reg. s 1.1502-13(f)(7), example 2(e).)

Facts. The facts are the same as in Example 3, except that P sells 10% of T's stock to Y on December 1 of Year 9 for $1.50 (rather than T issuing additional stock and becoming a nonmember). T's $90 distribution to P in Year 3 reduced T's $10 of earnings and profits to $0, then reduced P's $100 basis in T stock to $20. Under the matching rule, S takes $9 of its gain into account in Year 9 to reflect the difference between P's $.50 loss taken into account ($1.50 sale proceeds minus $2 basis) and the $8.50 recomputed gain ($1.50 sales proceeds minus $0 basis plus $7 recomputed DISA).

Apportionment. If not excluded pursuant to Title 18, California Code of Regulations, section 25137, the $1.50 gross receipts from P's sale of the T stock to Y is included in P's sales factor in Year 9. Both S's $9 gain and P's $.50 loss are treated as current apportionable business income in Year 9.

Example 6: Loss, rather than cash distribution.

(Refer to Treas. Reg. s 1.1502-13(f)(7), example 2(f).)

Facts. The facts are the same as in Example 3, except that T retains the loan proceeds and incurs a $90 operating loss in Year 3. The loss results in an earnings and profits deficit of $80 for T, but has no effect on P's basis in T's stock. Therefore, no DISA is created. T's $5 of earnings in Year 6 reduces its earnings and profits deficit to $75, but also has no effect on the stock basis. Because there is no DISA balance to take into account when T becomes a nonmember in Year 9, P's corresponding item and the recomputed item are both $0. Consequently, S's entire $90 intercompany gain continues to be deferred pending subsequent events.

Example 7: Intercompany reorganization.

(Refer to Treas. Reg. s 1.1502-13(f)(7), example 3.)

Facts. P forms S and B by contributing $200 to the capital of each. During Years 1 through 4, S and B each accumulate earnings and profits of $50, which is attributable to business income included in the combined reports of S, B and P. On January 1 of Year 5, the fair market value of S's assets and its stock is $500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives new B stock with a fair market value of $350 and $150 cash.

Treatment as a distribution under section 301 of the Internal Revenue Code. Under Treasury Regulation section 1.1502-13(f)(3), P is treated as receiving additional B stock with a fair market value of $500. Under section 358 of the Internal Revenue Code, P's basis of the additional B stock is $200 (P's basis in the relinquished S stock). Immediately after the merger, $150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) of the Internal Revenue Code as a distribution to which section 301 applies. Under section 381(c)(2) of the Internal Revenue Code, B is treated as receiving S's $50 of earnings and profits in addition to its own $50 of earnings and profits. Therefore, $100 of the deemed distribution is treated as a dividend and is eliminated from income under section 25106 of the Revenue and Taxation Code. The remaining $50 of the distribution reduces P's basis in the B stock from $400 to $350.

Apportionment. The reorganization has no effect on the sales factor. After the reorganization, S's property will be reflected in B's property factor at S's original cost.

<u>Example 8: Merger of members (Brother/Sister Merger)</u>

<u>Facts: P owns 100% of the stock of B and S, and P, B and S are members of a combined reporting group. There are 100 outstanding shares of B stock, with an accompanying DISA of $500. There are 100 outstanding shares of S stock, with an accompanying DISA of $1,000. S merges into B, with P receiving one share of B stock for each share of S stock surrendered. Accordingly, following the merger, P has 200 shares of B stock.</u>

<u>Amount of DISA Taken Into Account Following the Merger: Prior to the merger, there was a $5 DISA attributable to each share of B stock. (500 ÷ 100 = 5) Therefore, for each share of B's stock that that might have been disposed of prior to the merger, P would have taken into account $5 of income or gain. Similarly, prior to the merger, there was a $10 DISA attributable to each share of S stock. (1,000 ÷ 100 = 10) Therefore, for each share of S's stock that might have been disposed of prior to the merger, P would have taken into account $10 of income or gain. Following the merger, there is a $7.50 DISA attributable to each share of B's stock. (1,500 ÷ 200 = 7.50) Thereafter, when P sells or otherwise disposes of B stock, it must take into account $7.50 of income or gain per share.</u>

<u>Example 9: Subsequent capital contribution</u>

<u>Facts: P and S are members of a combined reporting group. P owns 100% of S's stock and has no basis in its shares of S stock. S has no earnings and profits.</u>

Subsequent capital contribution reducing DISA: S borrows $1,000 and distributes it to P. The result is that P has a $1,000 DISA attributable to its shares of S stock. During the year following the creation of the DISA, P makes a $2,000 capital contribution to S. The capital contribution is first applied against P's $1,000 DISA attributable to its shares of S stock, which is eliminated. The remaining $1,000 increases P's basis in its shares of S stock in accordance with section 24916 of the Revenue and Taxation Code

Example 10: Transferring stock with a DISA balance

Facts: P and S and T are members of a combined reporting group. P owns 100% of T's stock. P and T each own 50% of S's stock. Initially, P and T each had a separate basis in S's stock of $500. However, due to an excess distribution, P has a $400 DISA attributable to its stock in S. T does not have a DISA attributable to its stock in S. P transfers its S stock to T.

Reducing DISA to reflect transferee's basis: After P transfers its S stock to T, the $400 DISA attributable to P's stock reduces T's original basis in its stock in S. Thereafter, T has a $100 basis in the 100% of S's stock that it holds.

(g) (NO REVISIONS)

(h) (NO REVISIONS)

(i) (NO REVISIONS)

(j) Miscellaneous operating rules.

Except as otherwise provided, this regulation applies the provisions of Treasury Regulation section 1.1502-13(j) relating to miscellaneous operating rules; in addition, the provisions of subsections (j)(5), (j)(6), and (j)(7) of Treasury Regulation section 1.1502-13 shall not apply.
(1) Subgroups.

(A) If a change occurs in the composition of the combined reporting group, but both S and B either remain members of the same combined reporting group or leave the combined reporting group together and remain unitary with each other, such a change alone will not cause S's intercompany items to be taken into account under the acceleration rule contained in subsection (d) of this regulation.

(B) If the event which causes the combined reporting group to change as described in subsection (j)(1)(A) of this regulation also causes S's intercompany items to be taken into account in a federal consolidated return, then S may make an irrevocable election to take those intercompany items into account in the same period for California purposes. The election is made by reporting the income, gain, deduction or loss on a timely filed original tax return. If this election is not made, then S and B must maintain sufficient records to track the intercompany gain or loss which has been taken into account for federal purposes but which remains deferred for state purposes.

(C) Examples. The application of subsection (j)(1) can be illustrated by the following examples.

Example 1: S and B sold.

P is the principal corporation in a combined reporting group in which S and B are members. P sells S and B to Y, an unrelated entity. S and B remain unitary after the sale. The sale of S and B does not cause S's intercompany items to be taken into account under the acceleration rule. Therefore S's intercompany items will remain deferred until subsequent events cause those intercompany items to be taken into account under either the matching rule or the acceleration rule. However, if the sale of S and B caused S's intercompany items to be taken into account in the federal consolidated return, the taxpayer may elect the same treatment under subsection (j)(1)(B) of this regulation by taking the intercompany items into account on its timely filed original California return.

Example 2: S and B excluded by water's-edge election.

Assume the same facts as in example 1, but instead of selling S and B to Y, the taxpayer members of the combined reporting group make a water's-edge election. S and B are foreign corporations and are wholly excluded from the water's-edge combined report as a result of the election. Because S and B left the combined reporting group together as a result of the water's-edge election, the water's-edge election will not cause S's intercompany items to be taken into account under the acceleration rule if S and B are still unitary immediately after the election.

(2) Recognition of income from intercompany transactions occurring prior to entering the state.

(A) Intercompany transactions as defined in subsection (b)(1) of this regulation shall include those transactions which occur prior to any member becoming taxable in this state if S and B would have been members of the same combined reporting group had any unitary member been taxable in this state in the year of the transaction.

(B) To the extent that intercompany transactions would have qualified for an election to be treated on a separate entity basis under subsection (e)(2) of this regulation but for the fact that no member of the combined reporting group was a California taxpayer in the year in which such an election would have been required to be made, a retroactive election under subsection (e)(2) of this regulation will be deemed made. The deemed election shall apply to all intercompany transactions described by subsection (j)(2).

(C) Examples. The application of this regulation to transactions occurring prior to entering the state can be illustrated by the following examples.

Example 1: Sale outside of group after member enters the state.

Facts. S and B are members of a unitary group which conduct all of their business activity in the U.S. Both are members of a federal consolidated return group. In Year 1, when no member of the group is a California taxpayer, S sells land with a basis of $100 to B for $110. S's $10 gain is treated as a deferred intercompany item in S and B's consolidated return. The land is used in the unitary business. In Year 2, a member of the unitary group becomes taxable in California. Prior to the member becoming taxable in this state, no event occurred which would have caused the intercompany item to be taken into account. In Year 3, B sells the land to Y for $130.

Matching rule. S's sale of the land to B is an intercompany transaction, and S's $10 gain is its intercompany item. S takes its intercompany gain into account in Year 3 to reflect the $10 difference between B's corresponding item of $20 from the sale to Y, and the recomputed corresponding item of $30 ($130- $100). This is the same result that would have occurred if S and B were unitary divisions of a single corporation and the transaction had been a transfer between divisions prior to the corporation becoming taxable within this state.

Apportionment. The land is included in B's property factor at S's $100 original cost basis. In Year 3, the $130 gross receipts from B's sale to Y, unless otherwise excluded by California Code of Regulations section 25137, will be included in B's sales factor. S's gain will be treated as current apportionable business income in Year 3.

Example 2. Retroactive election under subsection (e)(2).

Facts. The facts are the same as in Example 1, except that S and B do not file a consolidated federal return. The Year 1 intercompany transaction between S and B is reported as a $10 gain on S's separate return for federal purposes. An election to treat intercompany transactions between S and B on a separate entity basis could have been made if any member of the unitary group was a California taxpayer in the year of the transaction. Therefore, a retroactive election is deemed made under this subsection in Year 3, which is the year that S's intercompany item would otherwise be taken into account.

Example 3. S leaves the combined reporting group after a member enters the state.

Facts. The facts are the same as in Example 1, except that instead of B selling the land, the stock of S is sold in Year 3 and S becomes a nonmember of the combined reporting group.

Acceleration rule. Once the stock of S is sold, the effect of treating the unitary operations of S and B as divisions of a single corporation cannot be achieved. Therefore, under the acceleration rule of subsection (d) of this regulation, S's $10 gain is taken into account in Year 3 immediately before S becomes a nonmember.

Apportionment. The land will be included in B's property factor at S's $100 original cost basis until S's intercompany gain is accelerated. Immediately after S's gain is taken into account, the $100 value of the land in B's property factor will be increased to reflect B's $110 cost. S's intercompany gain will be treated as current apportionable business income in Year 3.

(3) Partially included water's-edge corporations.

(A) Coordination with section 25110(a)(4) of the Revenue and Taxation Code.

1. If S is a corporation partially included in a water's-edge combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code, and S enters into a transaction with another member of the water's-edge combined reporting group, the transaction is an intercompany transaction if the resulting income, gain, deduction or loss would, but for the provisions of this regulation, be included as apportionable business income in the water's-edge combined report under section 25110 of the Revenue and Taxation Code.

2. Except as provided in subsection (j)(3)(A)3. of this regulation, intercompany transactions include transactions where B is a corporation partially included in the combined reporting group immediately after such transaction pursuant to section 25110(a)(4) of the Revenue and Taxation Code, but only to the extent that the object of the intercompany transaction gives rise to income, gain, deduction or loss which would be included as apportionable business income in the water's-edge combined report under section 25110 of the Revenue and Taxation Code.

3. The sale, exchange or other transfer of stock of an affiliated corporation (as defined by section 25110(b)(1) of Title 18 of the California Code of Regulations) to a corporation partially included in the combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code will not be treated as an intercompany transaction unless the stock is considered to be a United States real property interest as defined in section 897(c) of the Internal Revenue Code.

4. Where either S or B was partially included in a water's-edge combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code, the intercompany item will be taken into account under the acceleration rule immediately before any income year in which either S or B has no includable income pursuant to section 25110(a)(4) of the Revenue and Taxation Code and is therefore excluded from the water's-edge combined reporting group. If, for any year, the includable income of S or B pursuant to section 25110(a)(4) of the Revenue and Taxation Code is

insubstantial, the staff of the Franchise Tax Board may permit or require the intercompany item to be taken into account under the acceleration rule immediately before such year.

5. Where B is partially included in a water's-edge combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code, the acceleration rule will apply to take an intercompany item into account to the extent the object of the intercompany transaction ceases to give rise to income, gain, loss, or deductions which would be included as apportionable business income in the water's-edge combined report under section 25110 of the Revenue and Taxation Code. For example, if intangible property gives rise to income includible in the water's-edge combined report under section 25110 of the Revenue and Taxation Code while held by B, but a disposition of such property results in foreign-source gain or loss under sections 861 through 865 of the Internal Revenue Code which is not included in the water's-edge combined report, then the disposition will trigger application of the acceleration rule to take into account S's intercompany items with respect to such property.

6. Where a sale, exchange or other transfer of stock to a corporation included in the water's-edge combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code has been treated as an intercompany transaction under subsection (j)(3)(A)3. of this regulation, the acceleration rule will apply to take into account intercompany items arising from that intercompany transaction if the stock ceases to be a United States real property interest as defined in section 897(c) of the Internal Revenue Code.

(B) Coordination with section 25110(a)(6) of the Revenue and Taxation Code.

1. Definition. For purposes of subsection (j)(3) of this regulation, the term "partial inclusion ratio" shall refer to the ratio described in section 25110(a)(6) of the Revenue and Taxation Code, and the regulations thereunder, for determining the includable amount of income and apportionment factors for a partially included corporation described in section 25110(a)(6) of the Revenue and Taxation Code.

2. A transaction between a corporation included in a water's-edge combined reporting group pursuant to section 25110(a)(6) of the Revenue and Taxation Code and another member of the combined reporting group will be an intercompany transaction to the extent of that corporation's section 25110(a)(6) partial inclusion ratio (as provided by section 25110(a)(6) of the Revenue and Taxation Code) for the income year.

3. If both S and B are corporations included in a water's-edge combined reporting group pursuant to section 25110(a)(6) of the Revenue and Taxation Code, the partial inclusion ratios of both S and B must be applied

to determine the portion of the transaction that will be treated as an intercompany transaction.

4. Where either S or B is included in a water's-edge combined reporting group pursuant to section 25110(a)(6) of the Revenue and Taxation Code, the intercompany item will be taken into account under the acceleration rule immediately before the first income year in which the partial inclusion ratio for either S or B is an amount equal to or lower than 50% of its partial inclusion ratio for the year of the intercompany transaction. Regardless of whether the ratio decreases 50% or more below the intercompany transaction year partial inclusion ratio, the acceleration rule will apply to take the intercompany item into account if the partial inclusion ratio is less than 10%.

5. If subsection (j)(3)(B)4. of this regulation applies, then, as an alternative to the application of the acceleration rule provided by that subsection, the taxpayer may elect to have the acceleration rule apply to take into account only a proportionate share of the intercompany item relative to the amount of the decrease in the partial inclusion ratio. If further decreases in the partial inclusion ratio occur in subsequent years, additional portions of the intercompany item shall be taken into account under the acceleration rule in proportion to such decreases. However, if in any income year the partial inclusion ratio is below 10%, any remaining intercompany items shall be taken into account and the election provided by this subsection shall not apply. The election shall be made by reporting the proportionate share of the intercompany item on a timely filed original tax return for the first year in which the partial inclusion ratio decreases 50% or more below the intercompany transaction year partial inclusion ratio. As a condition of this election, the taxpayer must maintain books and records sufficient to identify the amounts of intercompany items, the annual partial inclusion ratios, and the application of this provision to the intercompany items.

6. Where both S and B are included in a water's-edge combined reporting group pursuant to section 25110(a)(6) of the Revenue and Taxation Code, and the partial inclusion ratios of both S and B decrease 50% or more below their respective intercompany transaction year partial inclusion ratios, the acceleration methodology of subsection (j)(3)(B)5. of this regulation shall be applied in proportion to the greater of either (1) the amount of decrease attributable to S or (2) the amount of decrease attributable to B.

(C) Separate entity election for transactions with partially included entities. See subsection (e)(2)(B) of this regulation for application of the election to treat transactions on a separate entity basis with respect to transactions with partially included entities.

(D) Examples. The application of this regulation to partially included entities in a water's-edge combined report is illustrated by the following examples.

Example 1: Intercompany sale of land by an entity included pursuant to section 25110(a)(4) of the Revenue and Taxation Code.

Facts. S is a foreign corporation with U.S. branches that are included in a water's-edge combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code. S has a basis of $70 in land which it uses in its U.S. trade or business operations. On January 1 of Year 1, S sells the land to domestic corporation B for $100. On July 1 of Year 3, B sells the land to Y for $110.

Matching rule. But for the provisions of this regulation, S's $30 gain from the sale to B would be treated as U.S. source income and included in the water's-edge combined report under section 25110 of the Revenue and Taxation Code. However, the transaction is an intercompany transaction and S's $30 gain is an intercompany item. S takes its intercompany item into account under the matching rule in Year 3 to reflect the $30 difference for the year between B's corresponding item of $10 and the recomputed corresponding item of $40.

Apportionment. To produce the result that would occur if S and B were unitary divisions of a single corporation, the intercompany sale of land will not be reflected in the sales factor in Year 1. In Year 3, unless otherwise excluded, the $110 gross receipts from B's sale will be included in B's sales factor. The land is attributable to B after the sale, and it will be reflected in B's property factor at S's $70 original cost basis until it is sold outside the water's-edge combined reporting group in Year 3. Both S's $30 gain and B's $10 gain will be treated as current apportionable business income in Year 3.

Example 2: Intercompany transaction where buyer is an entity included pursuant to section 25110(a)(4) of the Revenue and Taxation Code.

Facts. B is a foreign corporation with a U.S. branch which is included in a water's-edge combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code. In Year 1, domestic corporation S incurs expenses of $300 to provide engineering services to B in connection with the renovation of B's U.S. facility. B capitalizes the $500 fee which it pays to S for the services and computes depreciation on that basis. If S and B were divisions of a single corporation, only the $300 in expenses would be capitalized, which would result in smaller depreciation deductions.

Matching Rule. Because the engineering services are attributable to a facility used in the operation of U.S. business activities which give rise to income, gain, deduction or loss included in the combined report under section 25110 of the Revenue and Taxation Code, the performance of those services is treated as an intercompany transaction. S has intercompany income of $200 ($500 receipts less $300 expenses). S's intercompany income will be taken into account in subsequent years based upon the difference between B's corresponding depreciation (based on a $500 basis) and the depreciation recomputed as though S and B were divisions of a single corporation (based on a $300 basis).

Apportionment. As would be the case if the services were performed between unitary divisions of a single corporation, the transaction will not be reflected in the sales factor. If S's expenses with respect to the engineering services include payroll expenses, those expenses would be included in S's payroll factor in Year 1. When the renovated facility is placed into service in the unitary business, the $300 capitalized cost of the engineering services will be included in B's property factor. In each subsequent year, S's intercompany income taken into account and B's corresponding depreciation deduction will be treated as current apportionable business income for that year.

Example 3: Transaction not related to U.S. activities.

Facts. Assume the same facts as in Example 2, except that the engineering services relate to the construction of a plant in Brazil.

Matching rule. Although B is partially included in the water's-edge combined reporting group under section 25110(a)(4) of the Revenue and Taxation Code, the engineering services do not relate to an asset which will give rise to income, gain, deduction or loss which will be included in the water's-edge combined report under section 25110 of the Revenue and Taxation Code. Therefore, the performance of services is not treated as an intercompany transaction. S's income of $500 and expenses of $300 are taken into account in Year 1.

Apportionment. Gross receipts of $500 are included in S's sales factor.

Example 3a: Transaction allocated between U.S. activities and foreign activities.

Facts. Assume the same facts as in Example 2, except that the engineering services relate to the construction of two plants, one in the U.S. and one in Brazil. S's expenses with respect to the engineering services are allocated 55% to the U.S. activities under the rules in Treasury Regulation section 1.861. Therefore, 55% of the transaction will be treated as an intercompany transaction.

Matching Rule. S has intercompany income of $110 ($500 receipts less $300 expenses, multiplied by 55%). S's intercompany income will be taken into account in subsequent years based upon the difference between B's corresponding depreciation deduction and the depreciation deduction recomputed as though S and B were divisions of a single corporation.

Apportionment. Because 45% of the transaction is not treated as an intercompany transaction, S's $90 of non-intercompany income ([$500-$300] x 45%) will be treated as current apportionable business income in Year 1. Likewise, receipts from engineering services of $225 ($500 x 45%) will be included in S's sales factor in Year 1. The capitalized cost of the engineering services allocated to the U.S. plant is $165 ($300 total cost x 55%). When the U.S. plant is placed into service in the unitary business, the $165 capitalized cost will be included in B's property factor. In each subsequent year, S's intercompany income taken into account and B's corresponding depreciation deduction will be treated as current apportionable business income for that year.

Example 4: Asset ceases to give rise to U.S. source income.

Facts. Assume the same facts as in Example 2, except that the engineering services relate to the design of specialized equipment which is placed in service in B's U.S. facility by the end of Year 1. On December 31 of Year 4, the equipment is shipped to Germany for use in another plant owned and operated by B.

Matching rule. S has intercompany income of $200 (see computations in Example 2), a portion of which is taken into account in Years 2 through 4 to reflect the difference between B's corresponding depreciation deduction and the depreciation recomputed as though S and B were divisions of a single corporation.

Acceleration rule. In Year 4, the equipment ceases to give rise to income, gain, loss or deductions included in the water's-edge combined report under section 25110 of the Revenue and Taxation Code. Under the acceleration rule and subsection (j)(3)(A)5. of this regulation, S's remaining intercompany income is taken into account in Year 4.

Apportionment. The apportionment results of the transactions in Years 1 through 4 are the same as in Example 2. Because no gross receipts related to the transaction are generated in Year 4, the accelerated income is not reflected in the sales factor.

Example 5. Both Seller and Buyer partially included under section 25110(a)(4) of the Revenue and Taxation Code.

S and B are both foreign corporations with U.S. branches that are included in a water's-edge combined reporting group pursuant to section 25110(a)(4) of the Revenue and Taxation Code. S sells equipment which it uses in its U.S. trade or business operations to B for a gain. Thereafter, the equipment is used in B's U.S. trade or business operations. Except for the provisions of this regulation, S's gain from the sale of equipment would be treated as U.S. source income and included in the water's-edge combined report under section 25110 of the Revenue and Taxation Code. B's use of the equipment gives rise to income, gain, deduction or loss which will be included in the water's-edge combined report under section 25110 of the Revenue and Taxation Code. Therefore, because the requirements of subsections (j)(3)(A)1. and 2. of this regulation are both satisfied, S's sale of the equipment to B is treated as an intercompany transaction and subject to the rules of this regulation.

Example 6. Seller excluded from the water's-edge combined reporting group.

Facts. S is a foreign corporation which owns 100% of the stock of affiliated domestic corporations B and RP. RP is a United States Real Property Holding Corporation as defined in section 897(c) of the Internal Revenue Code. In Year 1, S has no income from U.S. activities, and is excluded from the water's- edge combined reporting group of B and RP.

In Year 2, S sells its stock in RP to B for a gain of $1,000. Because S's sale of RP is treated as a disposition of a United States real property interest as defined by section 897 of the Internal Revenue Code, S's income and apportionment factors attributable to that sale would, but for the provisions of this regulation, be included in the water's-edge combined report in Year 2. Therefore, the transaction is treated as an intercompany transaction. S's intercompany item is its $1,000 gain.

In Year 3, S has no income from U.S. activities, and is again excluded from the water's-edge combined reporting group of B and RP.

Acceleration Rule. The effect of treating the operations of S and B as divisions of a single corporation cannot be achieved once S is excluded from the water's-edge combined reporting group. Therefore, under the acceleration rule, S's $1,000 intercompany gain is taken into account in Year 2 (immediately before the income year in which S is excluded from the combined reporting group).

Apportionment. Neither the intercompany sale of RP stock nor the acceleration of the intercompany gain is reflected in the sales factor in Year 2. S's accelerated gain will be treated as current apportionable business income in Year 2.

Example 7: Seller included under section 25110(a)(6) of the Revenue and Taxation Code.

Facts. Corporation S is a controlled foreign corporation as defined in section 957 of the Internal Revenue Code, and is included in the water's-edge combined reporting group under section 25110(a)(6) of the Revenue and Taxation Code to the extent of its partial inclusion ratio. In Year 1, S sells land with a basis of $500 to domestic corporation B for $600. S's partial inclusion ratio for Year 1 is 66%. In Year 5, when S's partial inclusion ratio is 75%, B sells the land to Y for $650. At no time in Years 2 through 4 did S's partial inclusion ratio fall to 33% or lower (50% of the Year 1 ratio; see subsection (j)(3)(B)4. of this regulation).

Matching rule. $66 of S's $100 gain is an intercompany item and is deferred ($100 x 66%). The remaining $34 of S's gain is not included in the water's-edge combined report. In Year 5, B has a corresponding gain of $50 ($650-$600). For purposes of calculating the recomputed gain, S's original cost of $500 is increased by the amount of S's $34 non-intercompany gain. Therefore, the recomputed gain would be $116 ($650-$534). S's $66 intercompany gain is taken into account in the water's-edge combined report in Year 5 to reflect the $66 difference between B's $50 corresponding gain and the $116 recomputed gain.

Apportionment. Gross receipts of $396 from S's sale to B are included in the water's-edge combined report ($600 x 66%). If S and B were divisions of a single corporation, the transaction would not be reflected in the sales factor. Therefore, the $396 intercompany gross receipts shall be eliminated from S's sales factor under subsection (a)(5)(A) of this regulation. For purposes of B's property factor, the land will be reflected at S's cost basis under subsection (a)(5)(B)1. of this regulation, adjusted by any gain or loss recognized by S as a result of the non-intercompany portion of the transaction. The net value assigned to the land in B's property factor will be $534 ($500 cost basis to S + $34 non-intercompany gain).

Example 8: Buyer included under section 25110(a)(6) of the Revenue and Taxation Code.

Facts. On December 31 of Year 1, domestic corporation S sells land with a basis of $500 to corporation B for $600. Corporation B is a controlled foreign corporation as defined in section 957 of the Internal Revenue Code, and is included in the water's-edge combined reporting group under section 25110(a)(6) of the Revenue and Taxation Code to the extent of its partial inclusion ratio. B's partial inclusion ratio for Year 1 is 66%. On December 31 of Year 5, when B's partial inclusion ratio is 75%, B sells the land to Y for $650. At no time in Years 2 through 4 did B's partial inclusion ratio fall to 33% or lower (50% of the Year 1 ratio).

Matching rule. $66 of S's $100 gain ($100 x 66%) is an intercompany item and is deferred. S's remaining $34 gain is taken into account currently in Year 1. In Year 5, B has a corresponding gain of $50 ($650-$600). For purposes of calculating the recomputed gain, S's original cost of $500 is increased by the amount of the $34 non-intercompany gain taken into account by S. Therefore, the recomputed gain would be $116 ($650-$534). S's $66 intercompany gain is taken into account in the water's-edge combined report in Year 5 to reflect the $66 difference between B's $50 corresponding gain and the $116 recomputed gain.

Apportionment. Unless otherwise excluded, S's sales factor in Year 1 will reflect gross receipts of $204 from the non-intercompany portion of the sale to B. The remaining $396 ($600 sales price x 66%) will be eliminated from S's sales factor under subsection (a)(5)(A) of this regulation. The valuation of the land for purposes of B's property factor is S's cost basis adjusted by any gain or loss recognized by S as a result of the non-intercompany portion of the transaction. The net value assigned to the land will be $534 ($500 cost basis to S + $34 non-intercompany gain). The $534 valuation will be included in B's property factor to the extent of B's partial inclusion ratio for that year. For example, if B's partial inclusion ratio was 50% in Year 2, the land would be reflected in B's property factor for Year 2 at $267 ($534 x 50%). In Year 5, unless otherwise excluded, $487.50 gross receipts from B's sale of the land to Y will be reflected in B's sales factor ($650 sales price to Y x 75% Year 5 partial inclusion ratio).

Example 9: Both Seller and Buyer included under section 25110(a)(6) of the Revenue and Taxation Code.

Facts. Assume the same facts as in Example 8, except that S is also a controlled foreign corporation as defined in section 957 of the Internal Revenue Code, and is included in the water's-edge combined reporting group under section 25110(a)(6) of the Revenue and Taxation Code to the extent of its partial inclusion ratio. S's partial inclusion ratio for Year 1 is 80%. On December 31 of Year 5, when S's partial inclusion ratio is 60%, B sells the land to Y for $650. At no time in Years 2 through 4 did S's partial inclusion ratio fall to 40% or lower (50% of S's 80% Year 1 ratio).

Matching rule. $52.80 of S's $100 gain ($100 x S's 80% Year 1 ratio x B's 66% Year 1 ratio) is an intercompany item and is deferred. Of S's remaining $47.20 non-intercompany gain, $27.20 is currently taken into account in Year 1 ($100 total gain x S's 80% Year 1 ratio = $80 of total gain includable in water's-edge combined report; less $52.80 deferred intercompany portion); $20 of non-intercompany gain is not included in the water's-edge combined report. In Year 5, B has a corresponding gain of $50 ($650-$600). For purposes of calculating the recomputed gain, S's original cost of $500 is increased by the amount of S's $47.20 non-intercompany gain. Therefore, the recomputed gain would be $102.80 ($650 sales price - $547.20 recomputed basis). S's $52.80 intercompany gain is taken into account in the water's-edge combined report in Year 5 to reflect the $52.80 difference between B's $50 corresponding gain and the $102.80 recomputed gain.

Apportionment. Gross receipts of $480 from S's sale to B ($600 x S's 80% Year 1 ratio) are included in the water's-edge combined report. Of that amount, $316.80 ($480 x B's 66% Year 1 ratio) is attributable to the intercompany transaction and will be eliminated from S's sales factor under subsection (a)(5)(A) of this regulation. Unless otherwise excluded, S's sales factor will continue to reflect the remaining gross receipts of $163.20. In Year 5, unless otherwise excluded, $487.50 gross receipts from B's sale of the land to Y ($650 x B's 75% Year 5 ratio) will be reflected in B's sales factor.

The valuation of the land for purposes of B's property factor is S's cost basis in the land adjusted by any gain or loss recognized by S as a result of the non-intercompany portion of the transaction. The net value assigned to the land will be $547.20 ($500 cost basis to S + $47.20 non-intercompany gain). The $547.20 valuation will be included in B's property factor to the extent of B's partial inclusion ratio for that year. For example, if B's partial inclusion ratio was 50% in Year 2, the land would be reflected in B's property factor for Year 2 at $273.60 ($547.20 x 50%).

Example 10: Intercompany transaction between Seller included under section 25110(a)(4) and Buyer included under section 25110(a)(6) of the Revenue and Taxation Code.

Facts. S is a foreign corporation with a U.S. branch which is included in the water's-edge combined reporting group under section 25110(a)(4) of the Revenue and Taxation Code. B is a controlled foreign corporation as defined in section 957 of the Internal Revenue Code, and is included in the water's- edge combined reporting group under section 25110(a)(6) of the Revenue and Taxation Code to the extent of its partial inclusion ratio. In Year 1, S sells land with a basis of $800 which it used in its U.S. trade or business activities to B for $1,000. B's partial inclusion ratio in Year 1 is 60%. In Year 4, when B's partial inclusion ratio is 65%, B sells the land to Y for $1,100. At no time in Years 2 or 3 did B's partial inclusion ratio fall to 30% or lower (50% of B's 60% Year 1 ratio).

Matching rule. Except for the provisions of this regulation, S's $200 gain from the sale to B would be treated as U.S. source income and included in the water's-edge combined report; therefore, the requirements of subsection (j)(3)(A)1. of this regulation are satisfied. $120 of S's gain ($200 total gain x B's 60% partial inclusion ratio) is an intercompany item and is deferred. S's remaining $80 non-intercompany gain is taken into account in the water's-edge combined report in Year 1. In Year 4, B has a corresponding gain of $100 ($1,100-$1,000). For purposes of calculating the recomputed gain, S's original cost of $800 is increased by the amount of the $80 non-intercompany gain taken into account by S. Therefore, the recomputed gain would be $220 ($1,100 sales price - $880 recomputed basis). S's $120 intercompany gain is taken into account in the water's-edge combined report in Year 4 to reflect the $120 difference between B's $100 corresponding gain and the $220 recomputed gain.

Apportionment. Unless otherwise excluded, S's sales factor in Year 1 will reflect gross receipts of $400 from the non-intercompany portion of the sale to B. The remaining $600 ($1,000 sale price x 60%) will be eliminated from S's sales factor under subsection (a)(5)(A) of this regulation. The valuation of the land for purposes of B's property factor is S's cost basis adjusted by any gain or loss recognized by S as a result of the non-intercompany portion of the transaction. The net value assigned to the land will be $880 ($800 cost basis to S + $80 non-intercompany gain). The $880 valuation will be included in B's property factor to the extent of B's partial inclusion ratio for that year. For example, if B's partial inclusion ratio was 55% in Year 2, the land would be reflected in B's property factor for Year 2 at $484 ($880 x 55%). In Year 4, unless otherwise excluded, $715 gross receipts from B's sale of the land to Y ($1,100 sales price to Y x B's 65% Year 4 partial inclusion ratio) will be reflected in B's sales factor.

Example 11: Depreciable asset sold to buyer partially included under section 25110(a)(6) of the Revenue and Taxation Code.

Facts. On January 1 of Year 1, domestic corporation S buys equipment with a 10-year useful life for $100 and begins to depreciate it using the straightline method. On January 1 of Year 6, S sells the equipment to B for $60. B is a controlled foreign corporation partially included in the combined reporting group under section 25110(a)(6) of the Revenue and Taxation Code. B's partial inclusion ratio is 40% in Year 6. B determines that the useful life of the equipment is 5 years from the date it was acquired by B.

Depreciation through Year 5, intercompany gain in Year 6. S claims $10 of depreciation for each of Years 1 through 5, and has a $50 basis at the time of the sale to B. Thus, S has a $10 gain from its $60 sale to B in Year 6. $4 of S's gain is an intercompany gain ($10 gain x B's 40% partial inclusion ratio) and is deferred. S's remaining $6 non-intercompany gain is taken into account currently in Year 6.

Matching rule. In each of Years 6 through 10, B's corresponding item is its $12 depreciation deduction ($60 basis / 5-year life). If S and B were divisions of a single corporation, the recomputed depreciation deduction would be the $10 annual depreciation for Years 6 through 10 based on S's $100 basis, plus an additional $1.20 of depreciation attributable to the $6 increase in basis resulting from S's non-intercompany gain ($6 non-intercompany gain / 5-year remaining life). Thus, in each of Years 6 through 10, S will take $.80 of its intercompany gain into account to reflect the difference between B's $12 corresponding depreciation and the $11.20 recomputed depreciation.

Apportionment. Unless otherwise excluded, S's sales factor in Year 6 will reflect gross receipts of $36 from the non-intercompany portion of the sale to B. The remaining $24 ($60 x B's 40% partial inclusion ratio) will be eliminated from S's sales factor under subsection (a)(5)(A) of this regulation. The valuation of the equipment for purposes of B's property factor is S's cost basis of $100. (Because S's $10 total gain from the sale to B does not exceed the depreciation already deducted by S with respect to the equipment, the basis is not adjusted by the non-intercompany gain. If the total gain had exceeded the amount of depreciation already deducted by S, then the valuation of the property in B's property factor would be increased by the 60% non-intercompany portion of the excess gain.) The $100 valuation will be included in B's property factor in each year to the extent of B's partial inclusion ratio for that year. For example, the equipment would be reflected in B's property factor in Year 6 at $60 ($100 x 60%). In each of Years 6 through 10, S's $.80 intercompany gain will be treated as current apportionable business income. B's $12 depreciation deduction will be included in combined report business income in each year to the extent of B's partial inclusion ratio for that year. For example, $7.20 of B's depreciation deduction would be included in combined report business income in Year 6 ($12 depreciation deduction x 60% partial inclusion ratio).

Example 12: Decreasing partial inclusion ratio.

Facts. Assume the same facts as in Example 8, except that B does not sell the land to Y in Year 5. In Year 6, B's partial inclusion ratio is 25%, a 62% decrease from B's Year 1 ratio of 66% (41% difference between 66% Year 1 ratio and 25% Year 6 ratio, divided by 66% Year 1 ratio, equals 62%).

Acceleration rule. Under subsection (j)(3)(B)4. of this regulation, the acceleration rule will apply to take S's intercompany gain of $66 into account in Year 5 (immediately before the income year in which B's partial inclusion ratio falls below the 50% threshold).

Example 13: Election made under subsection (j)(3)(B)5. of this regulation.

Facts. Assume the same facts as in Example 12, except that the taxpayer elects under subsection (j)(3)(B)5. of this regulation to have the acceleration rule apply to take into account only a proportionate share of the intercompany item. B's partial inclusion ratio is 33% in Year 7, 16% in Year 8, and 8% in Year 9.

Acceleration rule. In Year 6, $40.92 of S's intercompany gain would be taken into account ($66 intercompany gain multiplied by the 62% proportionate decrease between B's 66% Year 1 ratio and B's 25% Year 6 ratio). B's partial inclusion ratio rose in Year 7; but the Year 8 partial inclusion ratio represented a new low point. At 16%, the Year 8 partial inclusion ratio was 76% below the Year 1 ratio of 66% (50% difference between 66% Year 1 ratio and 16% Year 8 ratio, divided by 66% Year 1 ratio, equals 76%). Accordingly, $9.24 of S's intercompany gain would be taken into account in Year 8 ($66 intercompany gain x 14% incremental difference between 76% decrease and the 62% decrease that was previously recognized). In Year 9, B's partial inclusion ratio fell below the 10% floor, so S's remaining intercompany gain of $15.84 is taken into account.

(4) Earnings and profits. The timing rules of this regulation apply to the calculation of California earnings and profits. Therefore, the California earnings and profits of S will not reflect S's intercompany items until those items are taken into account under this regulation. However, when a member distributes an amount of money or property to another member, who in turn thereafter distributes no more than the same amount of money or the same property to another member, any DISA arising from the initial distribution will be treated as earnings and profits for purposes of determining the DISA, if any, arising from the second distribution.

Example 1: Same Amount of Money Distributed

Facts: P, B and S are members of a combined reporting group. P owns 100% of B's stock, while B in turn owns 100% of S' stock. S has no earnings and profits and B has zero basis in its shares of S' stock. Similarly, B has no earnings and profits and P has zero basis in its shares of B's stock.

Amount of Earnings and Profits Arising from Initial Distribution: S borrows $1,000, which it distributes to B. The result is that B has a $1,000 DISA attributable to its shares of S' stock. After receiving the $1,000 from S, B distributes the same amount to P. However, the $1,000 DISA that is attributable to B's shares of S' stock is treated as if resulted in an increase of $1,000 in B's earnings and profits. Thereafter, when B distributes the $1,000 to P, the distribution is treated as a $1,000 dividend to P. The $1,000 dividend to P similarly results in P increasing its earnings and profits by $1,000. (Pursuant to section 25106 of the Revenue and Taxation Code, the deemed $1,000 dividend to P would be eliminated for California tax purposes if it were actually taken into account.)

Example 2: Additional Amount of Money Subsequently Distributed

Facts: P, B, S1 and S2 are members of a combined reporting group. P owns 100% of B's stock, which in turn owns 100% of S1's stock, which in turn owns 100% of S2's stock. S2 has no earnings and profits and S1 has zero basis in its shares of S2's stock. S1 has no earnings and profits and B has zero basis in its shares of S1' stock. B has no earnings and profits and P has no basis in its shares of B's stock.

Amount of Earnings and Profits Arising from Initial Distribution and DISA Resulting From An Additional Amount of Money Subsequently Distributed: S2 borrows $1,000, which it distributes to S1. The result is that S1 has a $1,000 DISA attributable to its shares of S2's stock. After receiving the $1,000 from S2, S1 distributes the same amount to B. However, the $1,000 DISA that's attributable to S1's shares of S2's stock is treated as if it increased S1's earnings and profits by $1,000. Thereafter, when S1 distributes the $1,000 to B, the distribution is treated as a $1,000 dividend to B. B borrows an additional $1,000, which it combines with the $1,000 distribution it received from S1, and then B distributes $2,000 to P. The $1,000 dividend to B similarly results in B increasing its earnings and profits by $1,000. Thereafter, when B distributes $2,000 to P, $1,000 of it is treated as a dividend to P. However, the remaining $1,000 represents an amount in excess of B's earnings and profits and P's basis in B's stock. Therefore, the result is that P has a $1,000 DISA attributable to its shares of B's stock. (Pursuant to section 25106 of the Revenue and Taxation Code, the deemed $1,000 dividend to P would be eliminated for California tax purposes if it were actually taken into account.)

(5) Foreign country operations. To the extent that foreign country operations are included in the combined report, and the corporations engaging in those operations are not required to report intercompany transactions under a similar deferral method for federal income tax purposes or any other purposes, then intercompany transactions involving those foreign operations may be reported using the method used for consolidated financial reporting purposes if that method reasonably reflects income and approximates the result that would be obtained from use of the rules in this regulation. However, adjustments may be permitted or required for any transaction or series of transactions for which the financial reporting method does not produce a result which reasonably approximates the results that would have been obtained under this regulation.

(6) (Reserved for pass-through entity rules.)

(7) If the taxpayer fails to disclose its DISA balance on its annual tax return, the staff of the Franchise Tax Board may, in its discretion, require the amounts in the undisclosed DISA accounts to be taken into account in part or in whole in any year of such failure. In addition to disclosing its DISA balance, the taxpayer must also disclose all DISA balances that have been previously reduced and/or eliminated as the result of any subsequent capital contributions.

(8) Recordkeeping. Intercompany and corresponding items shall be reflected on permanent books and records (including work papers). See also Title 18, California Code of Regulations, section 19141.6.

(k) (NO REVISIONS)

NOTE: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25136, Revenue and Taxation Code.